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From Northeast Asia to Southeast Asia

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The Logo



To better represent the underlying ideas that gave birth to CSIS in 1971, the Centre uses as of 1989 the logo that figures on the front cover of this journal. The original, in bronze, was designed by Indonesia's renowned sculptor G. Sidharta and comprises a disc with an engraving of the globe, which serves as a backdrop to a youth with an open book on a cloth draped across his lap, his left hand pointing into the book, and his right raised upwards. All these elements combine to project the Centre's nature as an institution, where people think, learn and share their knowledge. Mankind is their concern and the world their horizon. The undressed torso symbolises open-mindedness and the absence of prejudice in the attitude of the scholars who work with the Centre, just as it is with scholars everywhere. The inscription reads "Nalar Ajar Terusan Budi", in the Javanese language, conveys the Centre's belief that "to think and to share knowledge are the natural consequences of an enlightened mind." It is a surya sengkala that is chandra sengkala - a Javanese traditional way to symbolise a commemorable year in the lunar calendar, adapted to the solar calendar system. It uses words that express the perceived meaning of the commemorated year while marking the year at the same time, with each word having a numerical value. Thus, the inscription, in reverse order, represents the year CSIS was established: 1971.

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From Northeast Asia to Southeast Asia

Sixty Years of Diplomatic Relations between Indonesia and China: The Challenges Ahead *Jusuf Wanandi* 179-187

Since the People's Republic of China was proclaimed on 1 October 1949, until the beginning of the 1990, China-Indonesia relationship had been estranged with political upheavals both in Indonesia (the abortive coup of the Indonesian Communist Party or PKI) and in China (the Cultural Revolution). But now in 2010, at the 60th anniversary of the relationship, we can witness that a lot of cooperation, both bilaterally and multilaterally (from APT, EAS, APEC to G20). Yet, with her emergence as a global economic giant, China has to 'share' power with the US, who has been influential in the East Asian region and is still winning over China with respect to hard power of armed force and soft power of culture. She does not need to pursue military arms race with the US, but simply 'limit the US option'. Strategic competition can be avoided by increased transparency of China's political system and inclusion of the US in East Asian institutions, such as the EAS.

Foreign Direct Investment from Northeast Asia to Southeast Asia *Thee Kian Wie* 188-212

This paper provides an overview of foreign direct investment (FDI) from the Northeast Asian countries (Japan, the East Asian NIEs and since the late 1990s China) to the major Southeast Asian countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam) from the early 1970s up to the present. After discussing the foreign investment policies of the Southeast Asian countries, the paper discusses the FDI flows from Japan and the East Asian NIEs, during the period from the early 1970s to 1985; the period from 1985 up to the Asian financial crisis; and the period after the Asian financial crisis. The paper concludes that FDI, including FDI from the Northeast Asian countries, into Southeast Asia has brought significant benefits to these Southeast Asian countries, because FDI does bring in capital as well as valuable infusions of advanced technologies and modern managerial methods and the much needed access to export markets.

G20: East Asian - Pacific Perspectives *Jusuf Wanandi and Maria M. Wihardja* 213-221

Not only does the G8 lack legitimacy, but also it should avoid creating a bloc of developed countries within the G20. The G20 Toronto Summit was

able to stir the richest G20 countries to commit to a 'growth friendly' fiscal consolidation although it was not enough to avoid a double dip. Much is left to be completed at the coming G20 Seoul Summit, including necessary financial reforms. However, the G20 Seoul Summit, must not be overshadowed by the ongoing crisis in Europe. It must stick to the 'Asian agenda' of structural and related reforms and adopt a 'beyond the crisis' focus. It is time for the East Asian - Pacific countries to pick up the momentum of global growth. With the revaluation of the Yuan on 21 June 2010, the move was timely and right because it responded to the need of China to adjust its monetary policy after her growth acceleration, shortage of migrant workers, rising inflation, and ballooning asset bubbles. The Chinese smartly chose the moment that was early enough to prevent a currency dispute at the G20 Toronto Summit.

Social Issues in Indonesia

Corporate Social Responsibility Policy in Indonesia: A Critical Assessment *Raymond Atje* and *Andrew Rosser* 222-236

In mid-2007 Indonesia became the first country to make Corporate Social Responsibility (CSR) mandatory when the national parliament passed Law 40/2007 on Limited Liability Companies. This Law has been widely criticized on the grounds that its requirements in relation to CSR will have a negative impact on the economy if they are implemented in the future. This paper suggests that the Law is also unlikely to promote more socially responsible behavior on the part of companies in Indonesia. We suggest that a better way forward, at least in the short to medium term, is for the government to pursue what has been referred to as the 'enabling environment' approach to CSR.

A Reassessment of Inequality and Its Role in Poverty Reduction in Indonesia *Daniel Suryadarma, Rima Prama Artha, Asep Suryahadi,* and *Sudarno Sumarto* 237-255

This study provides an overview of inequality in Indonesia for the period of 1984 to 2002. Unlike previous studies, we use real consumption expenditure that takes into account the high regional price disparity across regions in Indonesia. We found that, although inequality in general decreased during the crisis, it actually increased for those below the poverty line. This study also provides an estimation of 'distribution-corrected' growth elasticity of poverty for Indonesia. This proves to be an important explanation for the fact that the poverty rate decreased very rapidly between 1999 and 2002: because inequality during the peak of the economic crisis in 1999 was at its lowest level in 15 years.

Review of Developments

Political Stability and Party Dynamics *Sunny Tanuwidjaja* 256-266

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SIXTY YEARS OF DIPLOMATIC RELATIONS BETWEEN INDONESIA AND CHINA: THE CHALLENGES AHEAD[1]

Jusuf Wanandi

REVIEW OF THE BILATERAL RELATIONS

Only 6 months after the People's Republic of China (PRC) was proclaimed, Indonesia opened diplomatic relations with the PRC in accordance with her free and non-aligned foreign policy. Not too long thereafter China sent one of the three famous Huang's as ambassador to Indonesia (namely Huang Chen), while the two other Huangs were sent to Cairo and London. And it was at the Afro-Asia Conference in Bandung (1955) that the Chinese leadership under Premier Chou En Lai went out into the world for the first time in a big way. At the beginning, this relationship was one where both sides had many domestic challenges and therefore not many extraordinary things happened. An important development that arose from the goodwill created by the Bandung Conference was the resolution of the problem of dual citizenship of the Indonesian Chinese based on the proposal of the Indonesian government. A Treaty was signed to that effect, implemented after a new law on Citizenship for the Republic of Indonesia was promulgated in 1958.

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[1] This is an edited version on the author's speech at the seminar: "Commemoration the 60th Anniversary of the Establishment of Diplomatic Relations between China and Indonesia," held in Beijing on 22 March 2010.

Bung Karno, who was promoting the idea of "Building the World Anew" in his speech at the General Assembly of the UN in 1960, was very close to the Chinese since he thought that the old global system of governance under the UN was no longer relevant. He would like to establish the "Conference of the New Emerging Forces" or Conefo starting with Ganefo or "Games of the Emerging Forces" held in Jakarta in 1964 with Chinese assistance. But that did not go far because of political upheavals both in Indonesia and China with the abortive coup of the Indonesian Communist Party (PKI), and in China, when the 1966 Cultural Revolution unsettled everything, that smacked of the status-quo.

The incident of 30 September 1965 also led to a period of tensions between Indonesia and China, because the Chinese were accused of supporting the PKI to instigate such a coup. While political support among communist parties was common, and such solidarity was given to the PKI, there was, however, never any evidence of greater involvement of the CCP (Chinese Communist Party) in the abortive coup. While in Indonesia it created a political havoc and persecution against the PKI at large, the Cultural Revolution in China that lasted for 10 years was also not helpful to restoring relations, following the break in 1967 by Indonesia.

It took 23 years before these relations were restored in 1990, because Soeharto and the military were dead against the restoration of diplomatic relations. On the other hand, the Foreign Office under Adam Malik felt the need to restore the relationship to support Indonesia's diplomacy in trying to resolve various regional conflicts, such as the Cambodian conflict, where the Chinese influence had been substantial. In the early 1980s I wrote a piece in Tempo magazine arguing for opening of diplomatic relation with China if we really wanted to solve the Cambodian conflict, but to no avail. In 1983 I also reported to President Soeharto about the changes happening in China after the reforms announced by Chairman Deng Xiaoping at the Party Plenum of December 1978, and the need for opening up to China as a great country in East Asia. ASEAN, as part of a peaceful environment, will be important to China's efforts for development and modernization. And China also thought that Indonesia played an important role in South East Asia/ASEAN. Thus, there was already some dynamism to

opening diplomatic relations to China. However, again there was no response on the part of the then government.

It was only at the end of the 1980's that President Soeharto relented, after seeing how much change has happened in China and due to the lobbying of some of business-conglomerates under the leadership of a senior business executive, Soekamdani. The relationship was resumed in 1990 after the first meeting of President Soeharto and the then Foreign Minister Chen Qixen in Tokyo at the funeral of Emperor Hirohito in 1989.

Since normalization, the relationship progressed step by step because the two countries and peoples have been estranged for 23 years. But now in 2010, at the 60th anniversary of the relationship, we can witness that a lot of cooperation across the board have happened. Trade and economic cooperation has been in the foreground, but in other fields as well, including in people to people relationship, a lot of efforts have been made. In the political field, a lot of consultations and cooperation happened both at the bilateral as well as at the regional/ASEAN level. Military cooperation has been slow, understandably so, after the solidarity between the communist parties in history had hampered normalization for a long time.

That has changed, however, when the Chinese stopped the subversion into South East Asia in 1979 after Deng's visit to several ASEAN countries in 1978. Indonesia and China's relations should not be looked at the bilateral context only, although this has become more important, but also through ASEAN-China relations and through both countries membership in the APT (ASEAN Plus Three) and EAS (East Asian Summit) which have become important instruments for cooperation for both countries within the East Asia region. Now that both have become members of the G20, there is much more to cooperate about, including on global governance issues.

For all that to be effective, basic understanding towards each other is critical, since we have been cut off for so many years and it will not be so easy to catch up. More efforts to understand each other's developments in all fields and each other policies on many aspects of life are critical issues for our future relations since relations from now on could only be increasing by leap and bounds. With better understanding on both sides some of the residual misunderstandings and prejudices lingering from the past could be overcome.

THE CHALLENGES AHEAD

Sino-Indonesian cooperation is important for the region in the context of two main strategic developments. The first are global changes, and the second are regional changes. It has been widely accepted that recently economic power has been gradually shifting toward East Asia. The global economic crisis has only quickened this process. It began with the excesses at the centers of international finance, namely the US and Europe. East Asia has been more resilient to impacts of this crisis. Therefore, this region has been able to overcome the crisis sooner than other regions. This situation has come about, partly, because of the lessons that East Asians have learned from the crisis of 1997-1998, which resulted in all East Asian states accumulating greater financial reserves. In addition, they also became more willing to adopt a pro-active stance in counter-cyclical spending to get their economies moving again.

Furthermore, they worked to establish new development paradigms that are less dependent on exports. Today, the region is better prepared and has been more willing to carry out necessary structural reforms. This needs to be undertaken to achieve a certain level of national resilience and to allow countries to face future crises more effectively. This requires more domestic-oriented structural reforms, provisions of better safety nets; more attention to healthcare, education and green policies; and assurances of adequate funding for these.

These changes are not easy, but East Asians do understand the necessity for structural reforms, and are willing to learn from each other and cooperate with each other. Even as these changes and shifts are happening in East Asia, the region should understand that the processes of change have global implications, and need time to develop fully.

On the global changes in the international economy following the financial crisis, both Indonesia and China have become members of the G20, in recognition that the G7/G8 has no more adequate authority and major changes are needed in global governance.

Here is a chance for both to cooperate intensively, because this is new to both and therefore they need to prepare for the expertise needed on global economic issues and governance. We also need to understand and participate in formulating new rules and the necessary

new institutions for global economic governance, because the Bretton Woods System, established in 1944, is outmoded.

Indonesia is inclined to depend on an East Asian grouping—consisting of China, Japan, Indonesia, Korea, and Australia—to prepare for the G20 Summits, because this will also strengthen East Asian cooperation at the global level. But it appears that China, who is a member of BRIC (a grouping acronym that refers to the related economies of Brazil, Russia, India, and China) and would like to stay among developing nations, is more comfortable with BRIC or the G5 in relation to the G7/G8 (the Heiligendam process), consisting of China, India, Brazil, South Africa and Mexico.

So far, Indonesia has cooperated with Korea and Australia in preparing for the G20 meeting in Seoul, and now that China's relations with Japan are improving under the Democratic Party of Japan (DPJ) and PM Hatoyama, the possibility of an East Asian cooperation for the G20 to be established is real[2]. In any case, Indonesia and China have to cooperate as two big developing nations for the G20; and for that purpose both have to have a lot more dialogues and cooperation on the global economic policies to be taken between the two of them.

And the ASEAN+3 (APT) could be useful for developing ideas and socialization of the issues and policies to the peoples of the region in addition to concrete cooperation to assist each other in restructuring their economies into more domestic oriented ones. In relation to the strategic developments of East Asia, China-Indonesia's cooperation on understanding China's development, particularly her political development, is important for East Asia.

China is a big country in many senses, and whatever she does in the neighborhood will have an impact on other countries in the region. To understand that she has no ambition for a "hard" hegemonic role for East Asia and will mainly depend on soft power will be important for them and for their evaluation about China. I believe this is what China means by a harmonious world. But it is also be important that the region accepts this in China's relation with the US. This could influ-

[2] On June 1, 2010, the former PM Hatoyama and the former Secretary-General Ozawa resigned around the issue of the inappropriate handling of political funds and the Okinawa Futenma base relocation. Naoto Kan took the place of the prime minister.

ence the US to be willing to share power in the region and to cooperate with China. There are strong reasons why the two countries should cooperate instead of oppose each other: to resolve the global economic crisis, to keep the world economy growing, to mitigate climate change, to promote energy security, and to ensure non-proliferation of WMD.

In addition, China-Indonesia cooperation is also important for East Asian regional institutions to succeed, such as the APT and East Asia Summit (EAS). The EAS particularly will become an important institution for strategic dialogue. It will help promote cooperation between China and the US that is so critical for peace, stability and development in the future.

This all requires intensive political dialogues and exchanges between China and Indonesia, occasionally at the highest level, as well as greater cooperation in the context of East Asian regional institutions, the EAS and the APT. The center- piece of strategic developments in East Asia is the relationship between China and the US. The US recognizes that she cannot solve many global problems and challenges alone any longer despite her likely continuation as one of the biggest economies in the next one or two decades to come.

In this regard, China—as the center of East Asia's development—has a crucial role to play while the East Asian region is becoming the most important part of the globe strategically. That is why President Obama is reaching out to the East Asian region. It is unlikely that this will lead to the creation of a G2 arrangement with China, because the strength and weight of both are not completely equal and China is not willing to be allied with anybody else. However, as a huge emerging market China has the size and the growth potential that will be decisive in solving common challenges: the global economic recovery, climate change, energy security and the proliferation of Weapons of Mass Destruction (WMD).

It has been expected that even after a successful visit of President Obama to China last November 2009, problems will remain and will continue to put significant strains in the relationship. This has come to the fore on the sales of military weapons to Taiwan and the meeting of President Obama with the Dalai Lama at the White House. In the eyes of China these two issues are "core interests" for the PRC and she expects that the US will see them as such as well.

We are living in a remarkable time of economic transformation, which caused shifts in relative economic weight of a scale and speed not seen before. And China is a key player in this transformation. While Chinese relative economic strength has grown remarkably, yet her place in the international order has not yet changed much. That is possible because geostrategic consequences of economic change will only come later. A status quo will remain until it suddenly falls when pressures become too great to bear. This tipping point might not be too far away, since based on some measures the Chinese economy might overtake the US to become the largest in the world around 2020 or so.

The US will continue to enjoy significant advantages over China in many aspects of power, including the soft power of culture and the hard power of armed force. But China does not need to overturn every aspect of US hyper-power, or compete against her globally in order to erode US primacy in Asia. And to do that China does not need to equal the US in military capability, but she needs to simply limit the US options. In this asymmetrical military competition between the US and China, in fact it is China that is in an advantageous position.

American values are highly attractive to others globally, including to Asia. But while they seek many of the American values, they do not believe that only American global leadership can deliver them. Of course, US decline has been predicted before, but this time it is different, because the challenge has hit its most fundamental source, namely its eclipse as the world's most productive economy. It is not only due to demographic factors alone, but the combination of demography and labour productivity.

Until now Asia has enjoyed the most prosperous and cooperative period in its long history due to stable and uncompetitive strategic relationships among Asia's most powerful states, the US, China and Japan, based on uncontested US primacy. However, it will be difficult to expect China to continue to accept US primacy as the basis of the regional order in Asia, while her own power approaches and exceeds America's. Yet, China would still like to remain peaceful and harmonious but it will not see the US primacy as a necessary condition for that.

There is no evidence that China is seeking "hard" militarized hegemony that we associate with Communist strategic policies of Sta-

lin and Brezhnev, but more of "soft" hegemony—something like in her history, where several dynasties were expecting to be recognized and accepted on certain policies, to shape the new kind of relationship between China and East Asia where China might have a certain veto power indirectly on those policies.

This will depend mostly on how the US will respond to China's rise. It could slowly withdraw, or it could share power with China, or it could try to maintain primacy by contesting China's challenge. Whatever US choice is going to be, Asia's international order would be different in the future. The main worry is about a strategic competition between the two. Other regional states will be faced with tough choices if this strategy is going to be chosen by the US.

There are two ways to weaken this possibility. One is transparency of the political system that is going to be developed by the Chinese leadership. This will give a lot more confidence to states in the region, because basically the Chinese leadership knows that they gradually have to open up the political system, while preserving stability. This should be done more openly and should be better explained to the outside world, which is not particularly well-versed in China's political jargon and has limited capacity to follow it due to language limitations.

That acceptance of the region could be one factor to convince the US that China is not another USSR that is going for world conquest and limiting the US role in East Asia. Second is by having a credible East Asian institution that includes the US as a member, in order to prevent misunderstandings and promote cooperation among its members, including between the US and China. This could open up more CBMs (confidence building measures), and to establish cooperative security in the region.

We can start with EAS (East Asia Summit) by inviting the US to join as a member. The US has shown an interest to do so as a means to stay in the region. That could, for the time being, concurrently be developed in tandem with bilateral alliances of the US, until the region completes a cooperative security arrangement that is workable.

This will help to convince both sides that cooperation and power-sharing is the better alternative for peace, stability and development to be maintained in the future for East Asia. One thing to be prevented

on the Chinese side is hubris because its achievements are so far still limited. Her increased power derives mainly from future trends in her economic, social and political power. Here Deng Xiaoping's warning against hubris should be heeded by the Chinese leadership.

FOREIGN DIRECT INVESTMENT FROM NORTHEAST ASIA TO SOUTHEAST ASIA

Thee Kian Wie

INTRODUCTION

This paper provides an overview of the surge of foreign direct investment (FDI) from Northeast Asia to Southeast Asia since the early 1970s up to the present, and the underlying factors which led to this surge. The second part of the paper describes developments of this FDI during the years after the Asian crisis and its prospects in the years ahead.

In this paper Northeast Asia refers to Japan and the three Asian Tigers, including Korea, Taiwan, and Hong Kong, since the bulk of FDI from Northeast Asia to Southeast Asia has mostly originated in these four Northeast Asian countries. Although Singapore is also classified as one of the four Asian Tigers and has invested extensively in the other Southeast Asian countries, particularly in Indonesia and Malaysia, besides being a recipient itself of FDI from the other Northeast Asian countries, this paper will focus mainly on Singapore as a recipient of FDI from the other Northeast Asian countries. However, data are available on total FDI from Singapore into all the other nine ASEAN member countries, but not differentiated according to the individual recipient ASEAN member country.

China's sustained rapid growth during the past three decades has led to its steadily rising demand for fossil fuels and other prima-

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ry commodities, and has also led China to engage in outward FDI in resource-oriented projects in other countries to secure its long-term supply of needed energy sources and raw materials, including in the resource-rich Southeast Asian countries. For this reason China is also included as an increasingly important Northeast Asian source country of outward FDI into Southeast Asia, besides being one of the largest host countries itself of inward FDI.

In this paper Southeast Asia refers to the five founding members of ASEAN (Association of Southeast Asian Nations), including Indonesia, Malaysia, the Philippines, Singapore, and Thailand, as well as Vietnam which has emerged as a significant Southeast Asian host country of FDI since it liberalized its foreign investment regimen in late 1987.

FOREIGN INVESTMENT POLICIES OF THE VARIOUS SOUTHEAST ASIAN COUNTRIES

The six ASEAN countries discussed in this paper have in general been pursuing relatively liberal policies toward foreign investment. However, among these ASEAN countries foreign investment policies have varied and still very widely, ranging from the relatively restrictive policies of Indonesia, the Philippines and Vietnam to the more liberal policies of Singapore, Malaysia, and Thailand.

In Indonesia since its independence up to the present there has been an intense debate about the appropriate role of foreign direct investment in the country. The lack of a popular and consistent consensus about the importance of FDI has therefore over time led to various shifts in government policies towards FDI. A restrictive policy stance in the early independence period in the 1950s was followed by a liberal policy towards foreign investment, but which was soon followed by a return to a more restrictive policy, and more recently back again to a more liberal policy, as reflected by the enactment of the new Investment Law in April 2007 which provided national treatment to foreign investors. However, this Law has been criticized because of its long Negative List of sectors closed to foreign investment or in which the foreign equity share is limited with no clear explanation of why this share is limited to a certain percentage.

In contrast to the lack of consistency in Indonesia's foreign investment policies, Singapore, and to a lesser extent Malaysia, have since

their independence up to the present pursued consistently liberal policies towards FDI. The Singapore government in particular has made great efforts to ensure a favorable investment climate characterized by transparent and predictable rules. Among the East Asian countries, Singapore has had the highest reliance on transnational corporations (TNCs) to develop industries and services targeted for promotion, and has done extremely well from it (Lall 1996a, 204).

To attract foreign investment, while inducing it to upgrade when Singapore chose to deepen its industrial and export structure, the Singapore government used a number of selective interventions to move from labor-intensive to capital- and skill-intensive activities. The Singapore government's interventions included heavy investment in physical infrastructure and in education at all levels to create the specific high-level technical skills needed for these capital- and skill-intensive activities. (Lall 1996b, 68).

While the foreign investment policies of Malaysia and Thailand have not been as liberal as those of Singapore, they have been much more liberal than those of Indonesia, and have become even more open over time (Hill 2004, 38). Although both Malaysia and to a lesser extent Thailand have pursued active industrial policies and promoted local enterprises in certain industries, they have pursued relatively liberal, non-interventionist foreign investment policies, particularly in the export-oriented industries (Lall 1996a, 202). Unlike Indonesia, neither in Malaysia nor Thailand has there been major shifts in their foreign investment regimes, even after the Asian financial crisis of 1997/98.

Like Indonesia, the Philippines has also pursued relatively restrictive foreign investment policies. Following the passage of the Foreign Investment act of 1991, the foreign investment regime was liberalized. This Act allowed foreign equity participation of up to 100% in all foreign investment activities not on the Foreign Investment Negative List. This Act and the easing of political tensions in the early 1990s, as well as the perceived resolve to pursue trade regulation and deregulation all contributed to improving the investment climate for foreign investors from the mid-1990s until the onset of the Asian economic crisis in 1997/98. However, compared to the other ASEAN countries, the Philippines is still a laggard in attracting FDI (Bautista & Tecson 2003, 158). However, since the Ramos administration in the 1990s up to the

present the Philippines has pursued increasingly liberal foreign investment policies.

As a socialist country, Vietnam until the mid-1980s was a centrally planned economy with its economic relationships mainly with the other socialist countries. However, in 1986 the Vietnamese government introduced an economic reform program (*doi moi*) .which also involved the opening up of the economy to interactions with the Western countries. In December 1987 the Vietnamese government enacted a relatively liberal Foreign Investment Law which led to a rapid inflow of FDI in the 1990s (Tuan 2004, 281). Vietnam's foreign investment policy, however, have been rather restrictive, as reflected by the pressure on foreign investors to form joint ventures with inefficient state-owned enterprises (SOEs), the requirement on foreign investors to have minimum capital shares, export requirements and local content. However, since Vietnam was preparing itself to enter the WTO (which it entered in 2007), it has gradually removed various restrictions on FDI that were incompatible with the TRIMS agreement (Tuan 2004, 303).

FOREIGN DIRECT INVESTMENT FROM NORTHEAST ASIA TO SOUTHEAST ASIA SINCE THE EARLY 1970S TO THE MID-1980S

The First Surge of Japanese Direct Investment into Southeast Asia

Japanese firms first started investing in Southeast Asia in the late 1960s. During the period 1970 – 1985 Japanese FDI consisted mainly of three types, namely:

Resource-oriented Investment

It aims to develop the natural resources for Japan's economy and to fuel its rapid industrialization. As a resource-poor country Japan lacks most natural resources important to its economy and its manufacturing industries and must therefore import them. Hence, one of the most important motivations for Japanese firms to invest abroad was the need to find an accessible source of natural resources under their own control. These firms were therefore assured of a large market in Japan if they invested in the development of foreign natural resources. Such investments provided them with the long-term security of a steady resource supply necessary for them to compete in industries which were

vertically integrated. Aware of the crucial importance of resource-oriented investment to Japan's economy, the Japanese government gave strong support to these investments (Sekiguchi & Krause 1980, 424).

Within the ASEAN countries, Japanese FDI was concentrated in resource-oriented investment. Between 1973 and 1985 resource-rich Indonesia was the main destination of Japanese resource-oriented investment, including in oil and gas. By 1985 48% of the total stock of Japanese FDI in ASEAN was concentrated in resource-oriented projects, mostly in Indonesia (Phongpaichit 1990, 30).

Domestic market-oriented Investment

It aims to take advantage of the protectionist import substitution industrial policies pursued by the Southeast Asian countries. A significant part of Japanese early FDI to Southeast Asia since the mid-1960s was therefore domestic market-oriented investment, particularly to Indonesia, the Philippines and Thailand which at the time were pursuing import-substituting policies (Yoshihara 1978, 48).

Import-substitution investment was welcomed in the Southeast Asian countries which were still in the early phase of industrialization (Yoshihara 1978, 49). With their traditional economic structure based on the primary sector, these countries were eager to welcome foreign investment in the manufacturing sector. To this end, they set up high tariff and/or non-tariff barriers, including quotas or total import bans, to bar imports of manufactured products to encourage local production for the protected domestic market.

Although Singapore is generally considered to be a country which successfully attracted export-oriented FDI, Singapore in the early 1960s also attracted domestic market-oriented investment when it started its own industrialization program. This encouraged several Japanese companies to invest in Singapore to protect their market. Singapore's domestic market was of course small, but the first rush of Japanese FDI into Singapore took place because of their expectation that they would have access to the wider Malaysian common market with the impending entry of Singapore into the Malaysian federation in 1963 (Yoshihara 1976, 50). Hence, the exit of Singapore from the Malaysian federation in 1965 was a severe setback to the expectations of these Japanese investors.

Although Indonesia, the Philippines and Thailand were also keen on attracting Japanese FDI into export-oriented manufacturing projects, they were not successful in this effort because of the 'anti-export bias' inherent in an import-substitution industrial strategy. Indonesia, in particular, was the least attractive for export-oriented investors. Although wages in Indonesia were low, labor productivity was even lower, thus causing the per unit labor cost of output to be relatively high (Yoshihara 1978, 48).

Export-oriented Investments

It aims to take advantage of lower production costs, particularly labor and land costs, in the Southeast Asian countries (Phongpaichit 1990, 29). A major factor inducing Japanese firms to set up manufacturing plants in Southeast Asia in the late 1960s was the availability of lower wage production workers in these countries. At the time an acute shortage of blue collar workers was developing in Japan which led to a rapid rise in wages. Hence, in order to maintain competitiveness in their domestic and export markets, Japanese firms relocated their production of labour-intensive products and processes (like parts assembly) to the low wage countries in Southeast Asia (Sekiguchi & Krause 1980, 424-5).

Having a production base in the lower-wage Southeast Asian countries also allowed the Japanese investors to circumvent the so-called voluntary export restraints (VERs) demanded by the United States and the other Western industrial countries to protect their labor-intensive industries. Another factor inducing Japanese investors to invest in Southeast Asia was their recognition that Japan's balance of payments was moving into a structural surplus. The Japanese government therefore tried to encourage Japanese FDI into the Southeast Asian countries as one of the ways to prevent a yen appreciation (Sekiguchi & Krause 1980, 425).

Foreign Direct Investment from the East Asian NIEs

Korea

Outward direct investment by Korean firms started around 1967. and thereafter grew rapidly during the second half of the 1970s. Du-

ring this period a large part of Korean direct investment in Southeast Asia, notably in Indonesia and Malaysia, took place in forestry to gain access to timber supplies for the Korea-based plywood industry. Korean FDI in Southeast Asia was also made in domestic market-oriented investment in manufacturing, and to a lesser extent in construction and trading (Jo 1981, 54- 65).

Outward Korean FDI in Southeast Asia was strongly supported by the Korean government to secure access to raw materials, expand exports of Korean products, and promote international cooperation with the Southeast Asian countries. To this end the Korean government offered a set of incentives, including protection from investment risks, financial assistance in the form of loans and guarantees, tax incentives and an information service (Jo 1981, 68).

Taiwan

Taiwan's outward direct investment in Southeast Asia started as early as 1959 when a Taiwanese firm invested machinery in a Malaysian cement plant, followed by a jute bag plant in Thailand. Since the early 1970s Taiwan's outward FDI in Southeast Asia increased rapidly, particularly in Indonesia and the Philippines (Ting & Chi 1981, 101).

Like Korean outward FDI in Southeast Asia, Taiwan's investors were motivated by the need to secure raw materials, particularly for Taiwan's plywood industry; to pursue profits by supplying host country markets, and to facilitate exports of Taiwanese products (Ting & Chi 1981, 102).

Hong Kong

Hong Kong's outward FDI in manufacturing in Southeast Asia started in the early 1960s, but only increased rapidly after the mid-1970s, particularly in Indonesia, Malaysia, the Philippines, Singapore and Thailand. Most of these Hong Kong investments in manufacturing in Southeast Asia were made by Hong Kong-based firms, and not by individuals or foreign-owned subsidiaries located in Hong Kong. Hong Kong FDI in Indonesia started after the Indonesian government enacted a foreign investment law in 1967. Most of these early Hong Kong investments in Indonesia took place in the textile industry (Chen 1981, 60-81).

Unlike Hong Kong's domestic market-oriented FDI in Indonesia, Hong Kong investments in Malaysia took place in export-oriented industries, as Malaysia has never pursued a strongly inward-looking pattern of industrialization as Indonesia did (Chen 1981, 82). Hong Kong's FDI in Singapore started in the early 1960s when Singapore had not achieved independence, although at the time Singapore had been granted self-government by Britain. During this period Hong Kong's FDI in Singapore mainly took place in the textile and garment industries (Chen 1981, 87).

Singapore

Like Hong Kong's FDI, the pattern of Singapore's FDI was also quite diversified with investments in the primary, secondary and tertiary sectors. However, a large part of Singapore's FDI was concentrated in manufacturing, particularly on the offshore island of Batam and in Malaysia's southern-most state Johor, and to a lesser extent in hotels and offices and construction (Thee 1988, 151).

Because of Malaysia's and Singapore's close geographical proximity and close historical and economic ties, it is not surprising that among the NIEs' investments in Malaysia, Singapore's FDI is the most significant. Singapore's FDI in Malaysia accounts for 32% of total FDI from the developing Asian economies. Singapore's FDI in Malaysia is largely concentrated in manufacturing. Although some of Singapore's investments in Malaysia were conducted by the subsidiaries of transnational corporations (TNCs) from the developed countries, most of Singapore's investments were conducted by indigenous Singapore firms. Most of these indigenous Singapore firms were relatively small firms rather than large firms (Tan 1988, 226).

The above overview of Asian NIE investments in the four ASEAN countries indicates that during the period 1970 – 1985 Indonesia attracted the largest number of investments projects from the four Asian NIEs. This is not surprising, since Indonesia had by far the largest domestic market which was growing very rapidly during this period, and thus was attractive for import-substituting investment. With its abundant natural resources, Indonesia was also an attractive location for resource-oriented investments. Moreover, during this period Indonesia enjoyed political and macroeconomic stability which were essential prerequisites for attracting FDI.

FOREIGN DIRECT INVESTMENT FROM THE NORTHEAST ASIAN COUNTRIES INTO THE SOUTHEAST ASIAN COUNTRIES, 1985 – 1997

The Second Surge of Japanese FDI into Southeast Asia

As a result of the steep yen appreciation (*endaka*) following the Plaza Accord in 1985, a second surge of Japanese direct investment to Southeast Asia took place which lasted through the mid-1990s up to the onset of the Asian economic crisis in 1997.

Two proximate causes have been elaborated to account for this second surge. First, as a result of the steep appreciation of the yen (*endaka*) following the Plaza Accord in 1985, Japanese products became more expensive. Facing the prospect of declining sales in their export markets, Japanese firms turned to relocating production of these products to countries with lower manufacturing costs, particularly Southeast Asia. Another likely reason was Japan's increased trade friction with the United States and the European Community about Japan's rising export surplus with these countries. To deal with this trade friction, a number of Japanese firms invested in the Southeast Asian countries to make use of these countries' unfulfilled Generalized System of Preferences (GSP) quotas to get around the trade barriers in the United States and the European Community countries against Japanese imports (Phongpaichit 1990, 33).

However, a more fundamental cause was Japan's economic transformation during the 1980s from a low wage industrial country relying on labour-intensive exports into a high-technology and high wage economy exporting more and more high technology- and high skill-intensive exports. During this period Japan's industrial structure also experienced a shift away from heavy industry and chemicals towards sophisticated electronics, information technology, and electrical machinery. Under these conditions outward FDI from Japan, particularly to the lower wage countries in Southeast Asia, was seen as the best way to remain competitive in the face of increasing competition from the East Asian NIEs and avoid the adverse impact of the yen appreciation (Phongpaichit 1990, 33– 48).

On the part of the Southeast Asian countries, particularly Indonesia and Malaysia, the initial hesitancy to welcome FDI had evapo-

rated as FDI was seen as a good way to overcome the adverse effects of the end of the oil boom on the balance of payments and accelerate economic growth (Phongpaichit 1990, 94). As a result of the open-door policies adopted by the Southeast Asian countries with respect to FDI, including Japanese FDI, FDI as a percentage of gross fixed capital formation in these countries, which during the period 1970 – 1983 had assumed a relatively significant importance (Parry 1988, 107), rose even further. The increase in Japanese FDI to ASEAN since the late 1980s through the first half of the 1990s is shown in Table 1.

Table 1. Japanese Direct Investment in the ASEAN Countries, 1989 - 1997 (in USD Million)

Year	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1989	631	673	202	1,902	1,276	-
1990	1,105	725	258	840	1,154	-
1991	1,193	880	203	613	807	-
1992	1,676	704	160	670	657	-
1993	813	800	207	644	578	-
1995	1,751	854	683	1,663	557	134
1996	1,829	717	527	1,505	524	159
1997	1,597	889	405	526	1,348	434

Source: For the period of 1989 - 1993, see: Kiyohiko Fukushima & C.H. Kwan, "Foreign Direct Investment and Regional Industrial Restructuring in Asia," in Nomura Research Institute and Institute of Southeast Asian Studies, 1995, *Foreign Direct Investment in Asia*, Table 1.2: 6; For the period of 1995 – 1997, see: The ASEAN Secretariat: *ASEAN Statistical Yearbook, 2005*, Table VI.12: 162.

The data in Table 1 show that during the period 1989 – 1997 Indonesia, Singapore and Thailand were in general the largest recipients of Japanese FDI. However, only in the case of Indonesia was there a steady upward trend in Japanese FDI over the period 1993 – 1996 which only declined slightly in 1997 when Indonesia was hit by the Asian economic crisis in 1997. The considerable increase of Japanese FDI in Indonesia in 1995 was due to the substantial investment deregulation package of June 1994 introduced by the Indonesian government to improve the country's investment climate.

During the same period there was no clear upward trend in Japanese FDI to Malaysia and Thailand. Japanese FDI to the Philippines during the same period declined steadily, as the country's endemic political instability and its sluggish-growing economy deterred foreign investors, including Japanese investors, from investing in the country. Vietnam, on the other hand, received a steadily rising inflow of Japanese FDI, although the absolute amounts were still modest compared to the other ASEAN countries. Looking at the data in Table 1, one can refer to Indonesia as the only Southeast Asian country which experienced a steady surge in Japanese FDI since the late 1980s up to the Asian economic crisis of 1997.

THE SURGE OF FOREIGN DIRECT INVESTMENT FROM THE EAST ASIAN NIEs TO SOUTHEAST

Asia since the Late 1980s up to the Asian Economic Crisis

Since the late 1980s up to the onset of the Asian economic crisis several '*push*' factors in the four East Asian NIEs were at work which led NIE firms, particularly from Korea and Taiwan, to invest in the Southeast Asian countries. The two major developments leading Korean and Taiwanese firms to relocate their operations to Southeast Asia were the substantial appreciation of their currencies and a rapid rise in wages in these two countries when their labour markets grew increasingly tight as a result of rapid economic growth in these countries.

Because of the large export surpluses which Korea and Taiwan had been able to accumulate in their trade with the United States, they came under increasing pressure from the US to revalue their currencies. At the beginning of 1989 the New Taiwan dollar had appreciated by more than 40 per cent over the late 1985 level, while the Korean won had appreciated by more than 20 per cent (Watanabe 1989, 173).

As a result of the sharp appreciation of their currencies and the steep rise in wages, Korea and Taiwan lost their comparative advantage in labour-intensive industries. Faced with these changes, Korean and Taiwanese firms could, like Japanese firms in the 1970s, have shifted their resources to other product lines in which their countries still had a comparative advantage. However, during the long period of rapid economic growth in their countries, Korean and Taiwanese firms

had accumulated significant managerial expertise and experience in overseas transactions (Watanabe 1989, 174). This gave these firms owner-specific advantages over other foreign and domestic investors, which they could profitably exploit in the lower-wage Southeast Asian countries by direct investment after high labour costs and currency appreciations had made operating in their home countries not profitable anymore.

Besides the above two 'push' factors, home government policies also played an important role in facilitating Korean and Taiwanese overseas investment. Before 1988 foreign exchange control regulations had prevented many Taiwanese firms from investing in Southeast Asia (Thee 1991, 61). The abolition of foreign exchange control by Taiwan's government in August 1986 therefore made Taiwan's overseas investment much easier.

The Korean government was also quite active in encouraging Korean firms to invest in Southeast Asia. To this end, it set up foreign investment consulting centers, including the Promotion Agency for Small-Scale Companies in 1986 and the Export Import Bank in 1987. It also sent study missions to Indonesia since 1987 to analyze the investment environment and provide information to prospective Korean investors, and organize orientation meetings on investment in Indonesia (Chang 1990, 21).

The Singapore government also actively promoted Singapore FDI into lower wage Indonesia and Malaysia because of its concern that rapidly rising land and labour costs had rendered Singapore's manufacturing industries less competitive. To this end the Singapore and Indonesian governments signed an agreement in the late 1980s to cooperate in developing Batam island (opposite Singapore) as an industrial estate to which Singapore's labour-intensive industries could relocate their operations (Thee 1991, 61-62). A similar agreement was signed by the Singapore and Malaysian governments to develop an industrial estate in the adjacent Malaysian state of Johor. The Singapore government in particular played an active role in the development of the Growth Triangle, which encompassed Singapore, the off-shore islands of Indonesia's province of Riau, and Johor state in Malaysia (Fukushima & Kwan 1995, 34).

Like the other three NIEs, Hong Kong in the 1980s experienced the same problems of high land and labour costs. However, unlike the firms of these three countries which relocated their labour-intensive operations largely to Southeast Asia, Hong Kong firms mostly moved their labour-intensive industries to China.

Besides the *'push'* factors at work in the Northeast Asian home countries, *'pull'* factors were also at work, particularly in Indonesia. After the steep drop in oil prices in 1982, the Indonesian government introduced a series of deregulation packages to simplify cumbersome investment licensing procedures to improve the investment climate for private investors, including foreign investors. After the sharp decline in oil tax revenues in 1982, the Indonesian government's fiscal capacity to finance development projects had sharply declined. It was hoped that increased private, including foreign, investment would take up the slack left by decreased public investment and thereby sustain the country's economic growth (Thee 1991, 58-9).

To generate more non-oil export revenues to offset the decline in oil export revenues, the Indonesian government also introduced a series of trade reforms to reduce the 'anti-export bias' of the highly protectionist trade regime, and thereby improve the international competitiveness of its non-oil exports. As a result of these successive deregulation measures and trade reforms, most of the new FDI projects, particularly from the East Asian NIEs, flowing into Indonesia after the mid-1980s were export-oriented projects. Approved export-oriented FDI projects in Indonesia rose steadily from 38% of the approved total in 1986 to 53% in 1987, to 72% in 1988, to drop again slightly to 72% in 1990 (Thee 1991, 64). The increasing relative importance of East Asian NIE investments in Southeast Asia during the second half of the 1980s is evident from the data in Table 2.

The above account shows that the surge of FDI from the Northeast Asian countries into Southeast Asia during the period 1985–1996 was triggered both by *'push'* factors internal to the Northeast Asian countries (yen appreciation and industrial restructuring in Japan, and currency appreciations and rising wages and land costs in the East Asian NIEs) and external *'pull'* factors, particularly political stability and rapid and sustained economic growth and a more favorable investment climate in these Southeast Asian countries.

Table 2. Relative Importance of East Asian NIE Investments in the ASEAN Countries, 1986 – 1990 (% of Total Inward FDI)

	1986	1987	1988	1989	1990
East Asian NIEs	15.3	11.4	30.6	21.9	31.7
Korea	1.5	1.6	4.5	9.9	8.8
Taiwan	2.2	0.5	20.6	3.3	7.1
Hong Kong	11.6	9.3	5.4	8.6	11.4

Source: Chia Siow Yue, " Progress and issues in ASEAN economic integration, " in Kawagoe & Sekiguchi,eds. , 1995, Table 9.4: 276.

NORTHEAST ASIAN FDI INTO SOUTHEAST ASIA AFTER THE ASIAN ECONOMIC CRISIS

During the period 1991–1996 all the six major economies of Southeast Asia, including Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam, which had just joined ASEAN, were growing strongly at 5 per cent or more. However, by mid-1997 the region was hit by a devastating financial crisis, as private capital (portfolio capital and short-term bank loans) flowed out of the region as a result of a sudden collapse of market confidence in the Southeast Asian countries. While in 1996 private capital amounting to USD 93 billion had flowed into the five worst-affected East Asian countries (Indonesia, Korea, Malaysia, the Philippines and Thailand), in 1997 a net capital outflow of USD 12 billion took place from these countries (Hill 1999, 1-2).

Among the Southeast Asian countries, Indonesia was by far the worst-affected country, experiencing an unprecedented economic contraction of almost -13.1% in 1998, almost double that of Malaysia's and Thailand's economic contraction of almost –7%. However, by 1999 the worst effects of the crisis had been overcome, as Indonesia, Malaysia and Thailand were able to reverse their economic contraction and achieve a modest positive growth, albeit at much lower rates than before the crisis (Table 3).

Table 3. GDP Growth of the Major ASEAN Countries, 1991 –1998 (in %)

GDP growth	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1991-5	7.8	8.7	2.2	8.5	8.6	8.2
1996	8.0	8.6	5.5	6.9	5.5	9.4
1997	4.7	8.0	5.1	7.8	- 0.4	9.0
1998	-13.1	- 6.7	0	1.3	- 6.5	5.0
1999	0.8	2.3	2.3	2.3	1.3	3.5

Source: Hal Hill, "Managing Capital Flows in an Era of International Financial Volatility," in Lindblad, ed., 2002, Table 1: 17.

Since the economic performance of the Philippines had not been as impressive as the other Southeast Asian countries, and not as politically stable as the other countries, it did not experience the vast capital inflows and sudden capital outflows experienced by Indonesia, Malaysia and Thailand. Vietnam did not experience vast capital in- and outflows, because unlike the other Southeast Asian countries, it had not yet introduced an open capital account.

Unlike volatile short-term capital inflows, foreign direct investment (FDI) flows are a more stable source of foreign capital which are not influenced by sudden shifts in market perceptions. Unlike other private capital inflows, FDI inflows into a developing country are based on a long-term view and thorough assessment of the economic prospects of a potential host country. The major considerations to set up an foreign-invested firm in a certain country are based on such factors as the political stability of a country and its macroeconomic stability, the availability of a skilled and disciplined labor force and a good physical infrastructure as well as national treatment of foreign-invested firms (i.e., enjoying the same treatment as domestic firms).

In view of the more stable nature of FDI as compared to other capital inflows, after the Asian economic crisis the crisis-affected Southeast Asian countries began to have a better appreciation of the benefits of attracting more FDI into their countries. For this reason the govern-

ments of the four crisis-affected ASEAN countries (Indonesia, Malaysia, the Philippines, and Thailand) introduced several promotion measures to attract more FDI into their countries, and reverse the decline in net FDI inflows which had occurred after the crisis. In Indonesia the four successive governments after the fall of President Soeharto (Presidents Habibie, Abdurrachman Wahid, Megawati Soekarnoputri and Susilo Bambang Yudhoyono) took several steps to improve the investment climate for foreign investors. These steps culminated in the enactment of a new Investment Law in 2007 which provided national treatment to foreign investors, that is the same treatment accorded to domestic investors.

Similarly, despite Malaysia's radical policy shift to introducing capital controls on short-term capital flows to make it much harder for short-term portfolio investors to sell their shares and keep the proceeds, and for off-shore hedge funds to drive down the Malaysian *ringgit*, the government continued to give priority to attract FDI. Despite the capital controls on short-term capital outflows, profit remittances and repatriation by foreign investors continued to be free of capital controls. Some new measures were also introduced to encourage new FDI into the country, such as allowing fully-owned subsidiaries in the manufacturing sector which would be established before 31 December 2000, regardless of whether they were export-oriented or not (Athukorala 2006, 5).

In Thailand the government opened up almost all manufacturing industries and the services sectors to new FDI, while existing restrictions on FDI in the financial and real estate sectors were considerably relaxed (Athukorala 2006, 5-6). Although the Philippines was not as hard hit by the crisis as the above three Southeast Asian countries, after the crisis the government introduced further measures to attract export-oriented FDI. Because of its close geographical proximity, Singapore experienced a steep decline in net FDI inflows in 1998, but in the following three years net FDI inflows into Singapore were even higher than before the crisis.

Table 4. Net FDI Inflows into the ASEAN Countries after the Asian Financial Crisis, 1995 - 2008 (in USD million)

Year	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1995	4,346	5,815	1,511	11, 503	2.070	1,780
1996	6,194	7,297	1,618	9,303	2,338	1,803
1997	4,678	6,323	1,245	13,533	3,882	2,587
1998	- 356	2,714	2,272	7,594	7,491	1,700
1999	- 2,745	3,895	1,247	16.067	6,091	1,484
2000	- 4,550	3,788	2,240	16,485	3,350	1,289
2001	- 3,279	554	195	15,649	5,061	1,300
2002	145	3,203	1,542	7,200	3,335	1,200
2003	- 596	2,473	491	11,664	5,235	1,450
2004	1,895	4,624	688	20,052	5,862	1,610
2005	8,336	4,064	1,854	14,373	8,048	2,021
2006	4,914	6,060	2,921	27,681	9,460	2,400
2007	6,928	8,401	2,916	31,550	11,238	6,739
2008	8.340	8,053	1,520	22,801	9,835	8.050

Note: Rounded figures
Source: The ASEAN Secretariat, *ASEAN Statistical Yearbook, 2007*, Table VI.1: 132-133.

These promotion measures bore fruit as the decline in net FDI outflows was soon reversed, except in the case of Indonesia where net FDI outflows, which started in 1996, continued up through 2003. While Malaysia never experienced net FDI outflows like Indonesia, net FDI inflows declined during the crisis, although in 1999, 2000 and 2002 net FDI inflows increased slightly again. The Philippines never experienced the severe adverse effects of the crisis, and even recorded an increase in net FDI inflows over the period 1998–2000, although in 2001 and 2002 net FDI inflows declined again. In Thailand net FDI inflows even rose in 1998 as the economy was contracting, but in the following years net FDI inflows continued to decline. Since Vietnam only experienced a mild adverse effect from the Asian financial crisis because of its closed capital account, its net FDI inflows only declined slightly after the crisis, and by 2004 net FDI inflows were almost the same as before the crisis (Table 4).

The above data in Table 4 should be interpreted with some caution, as these net FDI flows are derived from the balance of payments data of the various countries. These data, however, only provide a partial coverage of FDI flows into these countries. According to the standard definition, FDI consists of three components, namely equity capital; inter-company loans, mostly involving loans from the principal to their subsidiaries overseas; and reinvested earnings or profits.

The data on FDI flows in the balance of payments, however, capture only equity capital and inter-company loans, but do not include retained earnings. Hence, the omission of this third component of FDI can lead to an underestimate of the actual magnitude of FDI flows in a given host country, depending on how long a TNC has operated in that country and the nationality of the foreign firm in a certain host country of FDI (Athukorala 2003, 201). For instance, the available empirical evidence has indicated that the component 'retained earnings' of FDI is positively associated with the length of operations of foreign firms in a certain host country. The longer a foreign firm has operated in a certain country, the greater the component of reinvested earnings in the total investment amount of that foreign firm. The available evidence has also indicated that American TNCs show a general tendency to rely more on retained earnings for the expansion of their operations than the TNCs from other countries (Athukorala 2003, 201).

The data on net FDI outflows from Indonesia do not merely reflect an actual FDI outflow or foreign disinvestment, but to a lesser or larger extent also refers to the foreign loan repayments by the Indonesian subsidiaries of foreign TNCs to their principals overseas. In spite of this caveat, it was a matter of great concern to the Indonesian government that alone among the ASEAN countries, Indonesia was the only country which experienced net FDI outflows for a long time.

How did FDI from the Northeast Asian countries to the Southeast countries fare just before and after the Asian economic crisis? The data in table 5 clearly show the adverse impact of the crisis on Northeast Asian FDI in the Southeast Asian countries.

The data in Table 5 show that FDI from Japan into Southeast Asia declined steeply after the Asian crisis of 1997/98, and which only surpassed its pre-crisis levels in 2005. The decline in FDI from the Asian NIEs, however, was less steep than that of Japan. Asian NIE invest-

ment only surpassed its pre-crisis level in 2007, a year later than that of Japan, but in 2008 declined again to the level reached in 2006.

Table 5. FDI from the Northeast Asian Countries into the Southeast Asian Countries 1995 –2008 1) 3) (in USD Million)

Source country// Year	Japan	Asian NIEs 2)	Hong Kong	South Korea	Taiwan	China
1995	5, 642	2,845	1,271	584	914	134
1996	5,260	2,242	928	482	810	115
1997	5,199	3,521	1,885	710	914	59
1998	4,198	1,930	1,162	251	678	242
1999	1,663	1,632	698	523	403	48
2000	432	1,462	1,128	- 43	376	- 133
2001	1,596	2,052	- 411	- 240	2,703	144
2002	3,064	1,111	487	177	447	- 72
2003	2,308	1,348	225	550	573	187
2004	2,482	1,639	433	828	377	735
2005	7,212	1,087	586	507	- 6.8	538
2006	10,763	3,318	1,279	1,254	785	1,016
2007	8,382	5,619	1,622	3,125	872	1,227
2008	7,654	3,362	620	1,279	1,463	1,497

Notes: 1): Excludes FDI in Cambodia for the period 1995-2000; 2) East Asian NIEs excludes Singapore, but the data include NIEs' FDI in all the 10 ASEAN member countries.; 3). Rounded figures.

Source: The ASEAN Secretariat, *ASEAN Statistical Yearbook 2008*, Table VI.7: 134.Jakarta, July 2009,

This decline was caused by the decline in FDI from all three NIEs, Hong Kong, Korea and Taiwan, which was to a large extent due to the net FDI outflows from Indonesia. By 2006 the FDI flows from South Korea and Hong Kong had surpassed their pre-crisis levels, but Taiwan's FDI was still below its pre-crisis levels

The data in Table 5 also show that FDI from China has steadily increased since 2005. Before that, China's FDI in the ASEAN countries

also declined during the crisis, but it was only in 2006 that its FDI into the ASEAN countries rose steadily, after experiencing wide up-and-down swings during the period 1997-2005.

CONCLUSION

The above account of FDI from the Northeast Asian countries into the Southeast Asian countries has indicated that FDI from the Northeast Asian countries has played a significant role in the economies of Southeast Asia since the 1970s. A significant part of FDI from the resource-poor Northeast Asian countries, particularly Japan, Korea and Taiwan, and recently China, have taken place in resource-oriented investments, including forestry and mining, in the resource-rich Southeast Asian countries, particularly Indonesia. However, over the years Northeast Asian FDI in Southeast Asia have increasingly taken place in the manufacturing sector, initially in domestic-market-oriented FDI during the period of import-substituting industrialization in the 1970s, but since the early 1980s largely in export-oriented FDI when the ASEAN countries shifted to export-oriented industrialization, .

The major reason why since the mid-1980s most FDI from the Northeast Asian countries were export-oriented investments were that the export-oriented firms from Japan and the Asian NIEs, particularly Korea and Taiwan, relocated their export-oriented labour-intensive operations to the lower wage countries of Southeast Asia. The reason for this shift was the loss of comparative advantage of the Northeast Asian countries in labour-intensive operations in view of rapidly rising wages in these countries and the adverse effects of the steep currency appreciations in these three Northeast Asian countries.

FDI, including FDI from the Northeast Asian countries, into Southeast Asia can bring and has brought great benefits to these Southeast Asian emerging countries, because FDI does not only bring in capital, but also valuable infusions of advanced technologies and modern managerial and marketing methods and the much needed access to export markets. After the Asian crisis, however, the ASEAN countries experienced strong competition from China, which until recently has attracted the bulk of total FDI flowing into the East Asian countries. As wages have increased in China in view of its rapid growth and China has introduced more restrictive regulations against FDI, more FDI has

flown into Southeast Asia, including Indonesia which still recorded positive growth after the Global Financial Crisis (GFC) along with China and India.

To attract more FDI, the Southeast Asian countries, particularly Indonesia and the Philippines, have to continue their efforts to improve the investment climate in these countries to attract more FDI, including FDI from the Northeast Asian countries. The Southeast Asian countries should also endeavor to achieve rapid and sustained growth and to upgrade the quality of their labour force, because the experience of China has shown that a rapidly growing economy, the availability of a skilled and industrious labour force, and good physical infrastructure, are important determinants of the attractiveness of a potential host country to FDI, including FDI from the Northeast Asian countries.

With its open and transparent investment climate, its consistent foreign investment policy, its world-class physical infrastructure, and its strategic geographical location, Singapore will continue to attract large FDI inflows, much of which will serve as the regional headquarters of TNCs. With a favourable investment climate almost as good as Singapore, its macroeconomic stability, good physical infrastructure, and large natural resources, Malaysia will also continue to attract considerable FDI inflows.

Although post-Asian crisis Indonesia for many years was unable to attract much FDI, its relatively good economic performance in recent years, even after the onset of the GFC, has led to increasing FDI inflows since 2006 (Table 4).

Malaysia, the Philippines and Vietnam will also continue to attract FDI inflows involved in different stages of the production process in vertically integrated global industries. This is reflected by the rapid growth of electronic components from these three countries, which have benefited from the relocation of low-end component assembly by electronic TNCs from higher-wage Singapore and Malaysia (Athukorala 2006, 12). With its low wages, the lowest among the above six ASEAN countries, and its improving investment climate, Vietnam for the next few years will continue to attract export-oriented FDI in its labour-intensive industries. Because of its protracted political strife, Thailand, however, will for the time being be unable to attract significant inflows of FDI.

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G20: EAST ASIAN-PACIFIC PERSPECTIVES

Jusuf Wanandi and Maria M. Wihardja

THE G20 SUMMITS THIS YEAR

The G8 Summit held on the sidelines of the G20 Toronto Summit was an evidence that G8 was ineffective in resolving global issues, if not 'outdated', because it lacked the legitimacy to represent the world economy and global countries more generally. The outcomes from the G8 Summit were barely new: naming North Korea as the aggressor of the sunk South Korean warship, the five-year deadline to pull out from Afghanistan, a reaffirmation of the existence of Iran's nuclear program, and a statement about the unsustainable progresses in Gaza. The G8 members are also committed to accelerate programmes in reducing maternal, newborns and under five child deaths in developing countries, but the G8's unaccountability in fulfilling its development promises (for example, the 2005 Gleaneagles commitments) has been notorious (Sachs 2010). And what should not be done is creating a wall between developed and developing members by making the G8 a bloc within the G20.

Meanwhile, the G20 Toronto Summit was able to stir the richest G20 countries to commit to at least halve their budget deficits by 2013 and stabilize or reduce their debt-to-GDP ratio by 2016. This tough fis-

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cal consolidation commitment was fought hard by mostly the European countries, especially Germany, Britain, Canada and Japan, against the more flexible and 'growth friendly' exit strategy asserted by the US and supported by other developing countries including India and Brazil. In this regard, the US insisted that the timing of the exit, i.e., when countries withdrawing their fiscal stimulus programmes, must not hurt growth. So, the G20 leaders finally agreed that the implementations of fiscal consolidation measures would be differentiated according to national circumstances.

Other commitments reiterated in the G20 framework for strong, sustainable, and balanced growth reached during the Toronto Summit were:

1. strengthening social safety nets and enhancing corporate governance reform, financial market development, infrastructure spending, and greater exchange rate flexibility in some emerging markets;
2. pursuing structural reforms across the entire G20 membership to increase and sustain growth prospects;
3. making sure more progresses on rebalancing global demand[1].

To facilitate the process, the second-stage, country-led, consultative Mutual Assessment Process or MAP[2], will identify national measures and check for multilateral consistencies. These measures will be discussed at the Seoul Summit to coordinate actions. Essentially, MPA is an effort to make the G20 countries become mutually responsible for the global growth.

In the trade sector, the commitment to fight protectionism and promote trade and investment was renewed until the end of 2013. These included refraining from imposing any barrier to investments or trade in goods and services, and from imposing any WTO-inconsistent mea-

[1] The G20 Toronto Summit Declaration, 26-27 June 2010.

[2] "The mutual assessment process involves assessing and monitoring whether or not individual countries' policies and plans are collectively consistent with the G20's main objective of restoring high, sustainable and balanced global growth" (IMF, 2009). After all of the G20 countries submit their economic frameworks including policy plans and macroeconomic projections, the IMF with the support of other international organizations will check for internal consistencies (stage one), multilateral consistencies (stage two) and develop policy recommendations (stage three).

sure to stipulate exports. Other outcomes included commitments to a green recovery, the launch of the Global Agriculture and Food Security System and the launch of the SME Finance Challenge.

Pending main agendas to be agreed upon at or to be completed by the coming Seoul G20 Summit include:

1. financial sector reforms:
 a. agreements on capital adequacy and acceptable quality of capital as well as a renewed systemic financial system (recommendations should come from the Basel Committee on Banking Supervision and Financial Stability Board).
 b. global financial safety nets, in which Finance ministers and Central Bank governors were asked to prepare policies to consider the benefits and costs of these safety nets.
 c. IMF 2008 quota and voice reforms, which are to be fully ratified by some members, and other IMF governance reforms, including the size and composition as well as effectiveness of the Executive Board.
2. development:
 a. innovative financial inclusion for improving financial services among the poor.
 b. private sector involvement. In regards to this issue, Korea will hold a Business Summit, attended by the top 100 global CEOs, one day ahead of the Summit.
 c. measures on narrowing the development gap and reducing poverty to build national resilience, which will be done by the Working Group on Development established during the G20 Toronto Summit.
3. trade:
 a. reports on the benefits of trade liberalization for employment and growth by OECD, ILO, World Bank, and WTO.
 b. reports on the progresses on bringing the WTO Doha Development Round to a conclusion.

Dobson (2010) correctly asserted that the G20 Toronto Summit was only "a stop on the road to Seoul."

EAST ASIAN-PACIFIC COUNTRIES TO PICK UP THE MOMENTUM OF GROWTH[3]

In the upcoming G20 Summit in Seoul, East Asian Pacific countries must be careful not to focus narrowly on their own regional institutions and issues. Instead, they must aim to bring momentum to the global economic recovery and reforms. The agenda must resist being sidelined by the European crisis, and maintain a focus on Asian economies as they move beyond the financial crisis.

The formation of the G20 is a delayed recognition of the shifting of the global economy to the East, especially with the Chinese economy's emerging power. The cooperation of these economies represents an opportunity for significant global growth. Mahendra Siregar, the Indonesian Deputy Minister of Trade, said during an EABER-SABER conference in February 2010, that the 'G20 can be an international forum for structural reforms'. His words highlight the role that the G20 could play globally, especially in promoting growth in emerging economies.

This is a statement to be optimistic about. Structural reforms were well recognized by the G20 members at the G20 Toronto Summit as important factors for the global economic recovery: "Across all G20 members, we recognize that structural reforms can have a substantial impact on economic growth and global welfare" (The G20 Toronto Summit Declaration).

Structural reforms apply to all developed, emerging, and developing countries. For example, in China, these might take the forms of removing factor market distortions; in Russia, cutting the red tapes and giving more freedom to businesses; in more advanced economies, product, service and labour market reforms.

Constraints caused by border barriers to trade have been lowered over the years by international trade agreements, but 'behind the border' reforms remain a crucial issue. They include reforms of economic and legal structures, regulatory frameworks, competitiveness policy, bureaucracy and governance.

[3] This section is taken from Wihardja's article posted at the East Asia Forum (www.eastasiaforum.org) on 19 June 2010. This article is partly based on the private interview with Mahendra Siregar, Indonesia's G20 Sherpa, on 21 May 2010.

Additionally, a concrete reform agenda is needed to foster national resilience. This would include a social safety net, funding for health care and education and green policies. Structural reform will thus be important in maintaining the global economic growth momentum coming from the East Asian Pacific region and other emerging countries.

Structural reforms are politically sensitive matters in which international commitment, compliance and pressures might help on many fronts, including environmental issues. This was evident in the recent resignation of the Indonesian Minister of Finance, well known as one of the top Indonesian reformists and technocrats. Her non-compromising actions of reforms, including on top political and business elites, lost supports from the President, who favoured political stability over anything else.

Structural reforms are not new words in the context of rebalancing strategies for those who may have read Huang's factor market cost distortions hypothesis in China (Huang 2010a). Referred by Soesastro (2009a) as 'second generation reforms', structural reforms need to be discussed at the high political table not only because of the nature of the reforms that need political commitment and international support, but also because domestic structural reforms are indispensible to maintain a strong, sustainable, and balanced global economic growth.

The commitments to structural reforms by the G20 countries are already in place to some extent. Indonesia's G20 framework template (as a part of the MAP), for example, consists of three main elements, namely (1) monetary policy, (2) fiscal policy, and (3) structural reforms (including bureaucratic reforms and governance) and development. The implementation of structural reforms might be messy, but regional arrangements could help.

As Soesastro (2009b) put it: 'The new global economic governance structure will need to be based on representative institutions.' Regional institutions and arrangements, such as the new ASEAN+3 Macroeconomic Research Office, should be the organs of reform and actions through the G20. Only when regional institutions and global institutions are synchronized, can domestic reforms be successful. A survey of leaders' opinions that was conducted in the Asia and Pacific regions by the ADB (ADB 2010) suggests that we should not reinvent

the wheel, but strengthen and consolidate the existing regional institutions, including the CMIM arrangement and ASEAN+3 independent regional surveillance arrangement.

It would be wrong to put APEC and G20 in the same landscape, but it is worth considering how G20 can be an international forum for developing structural reform in the post LAISR period (APEC's Leaders' Agenda for Structural Reform expires in 2010) by making structural reform its medium and long term agenda. Structural reforms will also strengthen domestic microeconomic sectors that are not irrelevant to macroeconomic stability and national resilience.

The G20 Toronto Summit had delivered a timely discussion on the exit strategy and framework for strong, sustainable, and balanced growth but it was not sufficient to avoid the global economy to slip back to a crisis. Much is to be completed at the coming G20 Seoul Summit, including financial reforms that will need a "laser-like focus" (Dobson, 2010). It must also stick to the 'Asian agenda' of structural and related reforms and adopt a 'beyond the crisis' focus. East Asian and Pacific countries must lead at the Seoul Summit: they should set the tone for discussions and pick up the momentum for reform. This is a golden opportunity for the East Asian and Pacific countries to contribute to the global economic recovery.

CHINA'S DE-PEGGING AFTER TWO YEARS

On 21 June 2010, the Yuan strengthened to the highest level in nearly two year. On 28 June 2010, China set the exchange rate for the Yuan at its highest level in five years. This came less shockingly, though, after Chinese officials pledged on 19 June 2010, to continue with further reforms of the exchange rate policy and enhance flexibility (Wassener 2010). Since 2005, China has moved to a 'managed floating' exchange rate regime, but in 2008, she 'softly pegged' the Yuan to the USD. Appreciation of the Yuan was followed by appreciation of the other regional currencies in expectations of greater exports and strengthening national economies boosted by higher purchasing power of the Chinese.

The implication of this, if the revaluation stays modest, is probably not going to be significant in terms of re-balancing the internal

and external imbalances that the US claims to have hurt her economy[4]. Between mid-2005 and mid-2008, the period of 'managed floating' exchange rate regime, the Yuan appreciated by 22% against USD and by 16% on real effective terms. But, China's current account surpluses rose from 3.5% of GDP in 2004 to 10.8% in 2007 (Huang 2010c). In 2008, China adopted a 'soft peg' exchange rate regime to the USD in fears of declining exports and abrupt capital outflows due to the 2008 GFC. But, despite the continuation of the softly pegged regime to the USD, in March 2010, China's trade balance became negative.

Hence, appreciation of the Yuan alone, except if it is done to adjust to China's improved economic fundamentals, will not help to solve the internal and external imbalances. The efforts have to come from both the US and China on top of structural reforms, such as removing factor market distortions in China and changing saving behaviors in the US.

What can be applauded about the recent revaluation of the Yuan is the timing. First, China's 2008 'soft-pegging' to the USD was only a temporary response to the GFC that had to end, and this had been reiterated by the People's Bank of China (PBOC) Governor Zhou Xiaochuan on 6 March 2010 (Huang 2010b). Hence, PBOC was actually looking for the right moment to exit.

Second, China did not back down to the US pressure to hurriedly revalue the Yuan. Abrupt revaluing of the Yuan under pressures could distort the export market, cause inflationary pressures, and distort the global growth. The delay of the US Treasury Department's biannual report on international economic and exchange rate policy scheduled to be released on 15 April 2010, which could have named China as a currency manipulator, gave more time to China to react to the call without being put under tremendous pressures that could have created a 'trade war' between the two countries.

Third, it is time for China to adjust its monetary policy by exiting the expansionary monetary policy because of her growth acceleration, the shortage of migrant workers[5], rising inflation, and ballooning asset

[4] On 1 January 2010, Paul Krugman claimed that the US has lost 1.4 million jobs because of undervalued Yuan and supported trade protectionism against China. On 11 March 2010, he suggested the Treasury Department to name China as a currency manipulator. (Huang 2010b)

[5] China's factories' workers (especially the migrant workers) in the South, East, and North (including Honda car plant and Merry Electronics) have been holding strikes to demand higher

bubbles (Huang 2010d). Adjustments need to be made by simultaneously revaluing the Yuan and increasing the interest rate. Hence, the revaluation of the Yuan reflects improvements in China's economic fundamentals.

Fourth, revaluing the Yuan just a few days before the G20 Toronto Summit clearly indicates that currency issues are also political. The move by China to revalue the Yuan at this time prevented China from the currency debate at the Summit, shifting the focus of the Summit to other issues.

Overall, revaluation of the Yuan should be taken as a reaffirmation of the emergence of a new global economic power, namely East Asia.

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CORPORATE SOCIAL RESPONSIBILITY POLICY IN INDONESIA: A CRITICAL ASSESSMENT

Raymond Atje and *Andrew Rosser*

INTRODUCTION

In mid-2007, Indonesia became the first country to introduce mandatory legal requirements for Corporate Social Responsibility (CSR) when the national parliament (DPR) passed Law 40/2007 on Limited Liability Companies.[1] Article 74 of this Law states that limited liability companies (*perseroan terbatas*) that operate in Indonesia's natural resource sectors or that have activities that are connected with natural resources must implement 'corporate social and environmental responsibility' (clause 1); that they must fund the cost of this out of their own budgets (clause 2); and that companies that fail to comply with these provisions will incur legal sanctions (clause 3).

In late 2008, the Indonesian Chamber of Commerce (KADIN) and several other business organizations appealed to the Constitutional

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[1] Law 25/2007 on Investment, passed earlier in 2007, also contains provisions related to CSR. Article 15 states that investors in Indonesia 'have an obligation' to 'carry out Corporate Social Responsibility'. However, it does not require companies to incur any costs in meeting this obligation and only imposes administrative sanctions on investors that fail to carry out CSR, in contrast to Law 40/2007 which imposes legal sanctions. Leading figures in Indonesia's business community consequently do not see Law 25 as imposing a mandatory requirement for CSR (source: interviews with Noke Kiroyan, a founder of Indonesia Business Links (IBL) and Sofjan Wanandi, the head of APINDO, July 2008, Jakarta).

Court to have Article 74 declared unconstitutional. However, in April 2009, this Court rejected their appeal, with the result that Article 74 will remain law for the foreseeable future, even if it is currently unenforceable in the absence of an associated implementing regulation (Rosser and Edwin, forthcoming).

Article 74 has been widely criticized on the grounds that it would have a negative impact on the economy if it is implemented. On the one hand, it is argued, the Article would effectively impose an additional 'tax' on company profits by forcing companies to spend revenues that they would otherwise distribute to shareholders or reinvest in company activities. On the other hand, it would also create opportunities for government officials and politicians to extort bribes from companies by introducing new forms of restrictive regulation. These effects in turn would threaten the viability of many businesses, reduce private investment, and stymie economic growth.[2]

This paper suggests that Article 74 will also be ineffective in promoting its ostensible objective—that is, to make companies in Indonesia more socially responsible—because it will not ensure that companies rather than local communities and other social groups bear the costs of the negative externalities produced by the former's profit-making activities. We suggest that a more effective way of ensuring this outcome, at least in the short to medium term, will be for the government to pursue an alternative approach to CSR policy, namely the so-called 'enabling environment' approach.

In presenting this argument, we begin by examining the concept of CSR and making a case for understanding it in terms of negative externalities. We then present an assessment of Article 74 focusing on the extent to which it would deal with key challenges arising from this definition. In the final two sections of the paper, we then explore the pros and cons of 3 alternative approaches to CSR policy including the enabling environment approach and outline some specific measures that the Indonesian government should pursue to realize this approach.

[2] See, for instance, Kiroyan (2007), Lingga (2007), and Bennett (2007).

WHAT IS CSR?

There are a wide range of definitions of CSR (Idemudia 2003, 93-94) but two have been particularly influential. The first is that CSR refers to activities by businesses that incorporate social and environmental concerns above and beyond legal requirements (Boatright 2007, 368). Reflecting this definition, the European Commission, for instance, has stated that CSR is 'a concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders *on a voluntary basis*' (as quoted in Fox 2004, 30, italics added).

The second definition sees CSR in terms of business' contribution to sustainable development. For instance, the World Business Council for Sustainable Development has defined CSR as 'the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life' (World Business Council for Sustainable Development 2000: 10). The World Bank has more or less adopted this definition in full, changing it only by adding at the end the words 'in ways that are both good for business and good for development' (Ward 2004, 3). In Law 40/2007, Indonesia's law-makers decided to more or less replicate the Bank's definition, stating at Article 1(3) that CSR is 'a company's commitment to take part in sustainable economic development in order to improve the quality of life and environment, which will be beneficial for the company itself, the local community and society in general.'

In our view, however, CSR is best understood in terms of the negative externalities that companies produce as a result of their profit-making activities.[3] The point here, as Crouch (2006: 1535) has argued, is that the concept of CSR adds nothing to economic analysis if it is construed, as in the two definitions above, as including activities that form part of companies' normal profit-making activities; it is only analytically distinctive if it is used to refer to activities that cost companies something without contributing to profits. On this basis and drawing on the first definition above, Crouch (2006: 1534) argues that

[3] Works that employ such an understanding of CSR include Crouch (2006); Sumarto (2007); and Budimanta, Prasetijo, and Rudito (2008).

CSR should be defined as 'corporate externality recognition'—that is, 'behaviour by firms that *voluntarily* takes account of the externalities produced by their market behaviour' (italics added).

However, he also acknowledges that since negative externalities by definition represent instances of market failure, government intervention (in the form of the introduction of mandatory requirements for companies to engage in or refrain from particular activities and associated enforcement mechanisms) may be required to ensure that companies act in a socially responsible manner. As such, his arguments suggest that socially responsible behaviour on the part of companies is not in fact inherently voluntary at all but rather something that emerges from both voluntary actions on the part of companies and government-imposed requirements and enforcement mechanisms. Hence, paraphrasing Crouch, we prefer to define CSR as:

> "behaviour by firms that takes account of the externalities produced by their market behaviour as a result of both voluntary and government-mandated actions.".

The implication of this understanding of CSR—and in particular its linking of the concept of CSR to that of negative externalities—is that there are two key policy challenges related to CSR. The first is to ensure that companies internalise the costs of the negative externalities that they produce as a result of their profit-making activities. The second is to ensure that local communities and other groups in society who initially have to bear the costs of these externalities receive full and proportionate compensation. Only if both these challenges are met will the negative externalities produced by companies' profit-making activities be neutralized, society's resources be allocated to their most productive uses, and social welfare (or, more precisely, overall economic output) be maximized.

ARTICLE 74: AN ASSESSMENT

Article 74 is unlikely to be effective in meeting either of these challenges if it is implemented. For companies to fully internalize the costs of the negative externalities that they each produce, they would have to spend an amount on CSR activities that is equal to these costs. In theory, this can be achieved through the application of a Pigouvian

tax—that is, a tax on an externality generating activity. There are serious technical and cost-related difficulties with the use of such taxes: first, it is difficult to measure the costs of negative externalities, determine how much individual companies have contributed to these costs, and hence, calculate how much individual companies would need to pay in tax; and, second, even if these costs can be reliably measured and attributed to individual companies, it may be very costly to do so—so costly that it may outweigh the economic benefits of applying the tax in the first place.

But even if these technical and cost-related difficulties could be addressed, Article 74 would not ensure that companies in Indonesia, both individually and collectively, would spend enough on CSR activities to fully internalize the costs of their externalities. As it stands, it currently allows them to spend whatever they like on CSR. It may be that companies will be required to spend a specified amount on CSR in the implementing regulation related to Article 74 should one ever be issued by the government. But to address the challenges examined here, this amount will need to be specified in terms of the costs of negative externalities that individual companies produce rather than simply a percentage of revenues or profits, the most likely option given the politics surrounding Article 74.[4]

It is also unlikely that Article 74 would help with respect to the second challenge above—fully compensating local communities and other groups that initially bear the costs of negative externalities. For communities to be fully compensated, CSR funds—or the benefits of CSR activities—would have flow to these communities rather than to other groups. Again, there would be technical and cost-related difficulties in achieving this—in this case related to determining who has borne the costs of the externalities and hence who should receive the funds/benefits. But efforts to ensure that these groups are fully compensated would also be hampered by governance-related factors. In short, it is likely that the implementation of Article 74 would give rise to new forms of rent-seeking by political and bureaucratic elites that

[4] Article 74 originated with a proposal from the National Awakening Party for limited liability companies to set aside five percent of their profits for CSR activities. On the politics of Article 74, see Rosser and Edwin (forthcoming).

would undermine the extent to which CSR funds/benefits flow to the required groups.

Indeed, as soon as it became clear that the parliamentary committee that formulated Law 40/2007 had decided to introduce mandatory requirements for companies to carry out CSR, predatory elements within the national government began to position themselves to seize control over the pool of CSR monies that the new law would create. At the same time, since the passage of the Law, some regional governments have moved to introduce regional regulations (*peraturan daerah/Perda*) specifying how CSR monies are to be spent within their regions.[5] Such maneuvers suggest that CSR funds—or the benefits of CSR activities—would probably flow largely to predatory political and bureaucratic elements rather than to local communities and other groups negatively affected by corporate activities.

This risk is significant even if CSR monies are not transferred into government controlled funds or budgets. As one commentator has noted, in making CSR both mandatory and tax deductable (the latter being the effect of Art. 74 (2)), the government has created at least two more layers of bureaucracy—the first as a result of the paper filling needed to create compulsory CSR programmes and the second as a result of the need to claim back taxes from the tax office—in turn creating increased opportunities for rent-seeking by government officials (Bennett 2007). However, the risk that rent-seeking activity will prevent CSR monies from being used for the benefit of appropriate groups is even greater if CSR monies end up being channeled into government-controlled funds or budgets, as cases such as the reforestation fund illustrate. This fund, which was established during the New Order period ostensibly to finance reforestation projects was (mis)used by well-connected individuals to finance a range of activities unrelated to reforestation including, most controversially, the construction of the N2130 jet airplane by the state-owned airplane firm, IPTN.

[5] For instance, in late 2007, the governor and regional parliament of West Sumatra were discussing the introduction of a regional regulation on homelessness and begging requiring companies in the province to support efforts to address these problems through their CSR activities.

SOME ALTERNATIVES FOR INDONESIA'S CSR POLICY

What, then, are the alternatives for Indonesia in terms of CSR policy? The literature on CSR and development distinguishes between three broad approaches to CSR policy: the voluntary approach, the regulatory approach, and the 'enabling environment' approach.[6]

The Voluntary Approach

The first of these is based on the idea, articulated most famously by Milton Friedman (1970), that the only 'social responsibility of business is to increase its profits.' It assumes that social welfare will be maximised if market forces allocate society's scarce economic resources and governments do no more than set the broad 'rules of the game'—that is, create a regulatory environment that allows 'open and free competition without deception or fraud' (Friedman 1970). Hence, it suggests that, to the extent that governments regulate for CSR, this should be limited to creating an environment that makes it possible for companies to engage in socially responsible behaviour through voluntary self-regulation and other voluntary activities (Idemudia 2006: 93). However, it insists that such behavior should be firmly at companies' discretion and that government should do nothing to compel or promote such behaviour.

This approach is unlikely to be any more effective than Article 74 in addressing the two key policy challenges mentioned above. A key problem with this approach is that it ignores the fundamental tension between the profit maximization imperative faced by companies and the welfare of society as a whole. The profit maximization imperative means that, in the absence of strong government regulation and enforcement, companies have an incentive to pollute the environment, provide workers with poor working conditions, and/or engage in other activities that produce negative externalities if such activities enhance company profitability.

At the same time, to the extent that they voluntarily carry out 'CSR' activities, companies have an incentive to use them to enhance their profitability rather than to internalize the costs of their negative

[6] See, for instance, Idemudia (2006: 93-94).

externalities (Frynas 2005). Finally, this approach does little to ensure that local communities and other social groups who initially have to bear the costs of these externalities receive full compensation. Indeed, it implies that provision of such compensation should be entirely at the discretion of companies themselves.

The Regulatory Approach

Accordingly, some commentators have proposed a 'regulatory' approach to CSR (CORE nd; Oxfam International 2005; Heyneardhi 2005). In contrast to the voluntary approach, this approach recommends the introduction of legal measures that (i) penalize companies for engaging in activities that produce negative externalities and (ii) enable local communities and other social groups that initially bear the costs of these externalities to seek redress through the legal system. Typically, such measures entail, not a blanket requirement for companies to carry out CSR as in Law 40/2007, but prohibitions on specific actions such as pollution and providing employees with poor working conditions. The problem with this approach, at least within the context of developing countries such as Indonesia, is that it assumes that the government is able to properly enforce its laws, specifically those that prohibit socially irresponsible behavior. Within a context characterized by good governance, the regulatory approach can be reasonably effective in addressing the two aforementioned policy challenges as the experience of many Western countries attests. The credible threat of penalties puts pressure on companies to internalise the costs of the negative externalities that they produce as a result of their profit-making activities while the ability of local communities and other social groups to seek redress through the legal system ensures that they receive at least some compensation for doing so. But in countries characterised by poor governance such as Indonesia, it is likely to have little effect in these respects.

Proponents of a regulatory approach have responded to this problem by trying to persuade governments in rich countries to provide legal protection to communities in developing countries that suffer human rights or environmental abuses at the hands of multinational corporations (MNCs) where these communities are unable to access justice within their own countries. For instance, the Corporate Respon-

sibility Coalition (CORE), an umbrella organization that brings together Amnesty International, Action Aid, Friends of the Earth, Traidcraft, and War on Want among other NGOs, has pursued precisely this approach in the UK, calling on the British government to make it possible for communities in developing countries to seek compensation under British legislation for human rights and/or environmental abuses committed by British companies (CORE nd). But this approach is inherently limited in scope. Even if was adopted by all governments in rich countries—something that is unlikely because of the political power of MNCs—it would only address the problem of negative externalities produced by MNCs from rich countries, not those produced by domestic firms or MNCs from developing countries. It thus needs to be complemented by an approach to promoting socially responsible behavior on the part of companies that provides incentives for *all* companies to be socially responsible, regardless of national origin.

The Enabling Environment Approach

This third approach takes as its starting point the recognition that there is not always a 'business case' for CSR in developing countries—that is, businesses will not always find it in their own self-interest to act responsibly—and that government intervention will therefore be required to promote CSR. But it suggests that such intervention can take a wide range of forms, not just those envisaged in the regulatory approach. Fox (2004, 31), for instance, argues that government can promote CSR by acting as 'facilitator, partner, and endorser' as well as through its 'conventional mandating capacity.'

More specifically, he argues that government can adopt (i) *facilitating* measures such as enacting laws and regulations that require corporate 'transparency or disclosure on various issues' and developing 'non-binding guidance and labels or codes for application in the marketplace;' (ii) *partnering* measures such as 'combining resources with those of business and other actors to leverage complementary skills and resources to tackle issues within the CSR agenda;' and (iii) *endorsing* measures such as 'showing political support for particular kinds of CSR practice in the marketplace;' 'endorsing specific metrics, indicators, guidelines and standards or award schemes;' and, '"leading by example".....through public procurement practices' (2004: 32).

In essence, such measures seek to promote CSR by enhancing market-based pressure on companies to adopt CSR or, to put it in terms of the policy challenges identified earlier, by enhancing the business case for internalising externalities and ensuring that communities and other social groups are fully compensated for initially bearing the costs of these externalities. They do this in a number of ways: (i) by encouraging individuals to change their preferences *vis-a-vis* the products they buy, stocks they invest in, or firms they work for—this is an intended effect, for instance, of the 'political support' and public procurement measures; (ii) by rewarding companies that act in a socially responsible manner with business opportunities—this is also an intended effect of the public procurement measure; and (iii) by providing consumers, investors and workers with better information about the environmental and social impact of individual companies and their products, in turn helping them to realise preferences they might have for socially responsible or 'ethical' firms and products—this is the intended effect, for instance, of the corporate transparency/disclosure measure and the measure related to specific metrics, indicators, etc. By creating greater demand for socially responsible behaviour on the part of companies, the enabling environment approach suggests, companies will respond by supplying such behaviour.

In our view, the third approach represents the most promising way forward for Indonesia, at least until such time as the quality of governance in that country improves to the point where a regulatory approach is likely to be more effective. First, by harnessing the power of market forces, it would impose much greater pressure on Indonesian companies to adopt CSR than the voluntary approach, something that is necessary in the Indonesian context given the relatively weak business case for CSR at present.[7] Second, while elements of this approach could easily be derailed by corruption and poor governance—most notably the use of public procurement to encourage CSR—in general it is less likely to be subject to government failure than the regulatory

[7] The relatively weak business case for CSR in Indonesia is reflected, for instance, in the fact that membership of Indonesia Business Links, the main proponent of CSR within the Indonesian business community, consists overwhelmingly of Western MNCs. The only domestic firms that have so far paid much attention to CSR are ones that export to Western markets and that have to meet ethical quality standards to have continued access to these markets.

approach. This is because the role of government in this approach is limited largely to setting or endorsing regulatory frameworks for CSR (e.g., environmental and social reporting standards, product labeling systems) and promoting cultural or attitudinal change on the part of customers, investors and workers, rather than carrying out enforcement functions as in the regulatory approach.

To be sure, government would have some involvement in relation to enforcement—for instance, disputes over, say, the accuracy of corporate 'sustainability reports' and their conformity to environmental and reporting standards would still have to be resolved through the country's judicial system. But in general the approach relies much more on market forces for enforcement than government action, something that is likely to make it much more effective in the Indonesian context than a regulatory approach, given the poor quality of governance.

REALISING THE ENABLING ENVIRONMENT APPROACH IN INDONESIA

To realise the enabling environment approach in Indonesia, the Indonesian government needs to push forward with a number of initiatives, some of which it or other actors have already begun. It is impossible to detail all of these initiatives here but some of the most important are as follows:

- *Mandate a corporate reporting standard on CSR.* Law 40/2007 requires all limited liability companies to report on their CSR activities in their annual reports and to have the information they present audited by a public accountant (*akuntan publik*). But there is no standard governing how they should do this. The National Center for Sustainability Reporting (NCSR), a joint venture between the Indonesian Accountants' Association (IAI), several business representative organizations, and the Indonesia-Netherlands Association, is promoting use of the Global Reporting Initiative, an essentially voluntary reporting code. It initially envisaged a set of Indonesian Sustainability Reporting Standards that would be mandated, either by Capital Market Supervisory Agency (*Badan Pengawasan Pasar Modal*/Bapepam) or the Ministry of the Environment. But it gave up on this after opposition from MNCs. The

IAI, which produces the country's financial reporting standards, is not currently working on a CSR standard.[8] But, in light of the NCSR's abortive attempt to produce Sustainability Reporting Standards, it could step up to the plate, especially if encouraged to do so by the government. Importantly the IAI's standards have legal backing—under Law 40/2007 publicly listed companies are required to use them for financial reporting purposes. There is a weakness with use of these standards in as much as public accountants are not the best judge of companies' social and environmental responsibility; it would be better to establish a parallel set of auditing firms with specialized skills in environmental and social responsibility reporting and to have these audit separate sustainability reports. Indeed, this is what the NCSR initially envisaged.[9] But having public accountants audit sustainability reports, especially if prepared according to a mandatory standard, is better than not having any such audit process.

- *Carry out a public education program* about CSR and the various ways in which companies can work towards compliance with CSR objectives. While we have no evidence to support this view, our sense is that in general Indonesian consumers, investors and workers are not well informed about, for instance, the various NGO-sponsored product labeling schemes that exist (e.g. those promoted by the Rainforest Alliance, the Forest Stewardship Council, the Indonesian Ecolabelling Foundation, and the various backers of Fair Trade products), more official international CSR product standards such as ISO 26000, or the role of corporate sustainability reports. A public education program could not only increase public awareness of these tools and in doing shift consumer, investor, and worker preferences but also help those consumers, investors and workers who already prefer socially responsible companies and products to make more informed choices. In accordance with Fox's call or greater partnering

[8] Interview with an informed source, July 2008.
[9] Interview with an informed source, July 2008.

between government, business and NGOs, such a campaign would necessarily involve cooperation between these elements. Such a campaign could involve naming companies that have met particular codes or standards, effectively giving them a pat on the back while implicitly criticizing companies that have not done so.

- *Adopt a socially responsible public procurement policy*. In early 2007, Indonesia's Environment Ministry indicated that it would try to bring about changes to government procurement regulations to introduce a green public procurement policy. But such changes do not yet appear to have been made. We would recommend that the government move ahead with these plans, while expanding them to encompass the non-environmental aspects of social responsibility. At the same time, we would encourage the government to use standards such as those above as the basis on which it determines whether or not a product is socially responsible, in effect endorsing the wider use of these standards within the marketplace.
- *Encourage the use of sustainable and responsible investment strategies (SRI) by Indonesian investors*. Such investment strategies are not widely employed by Indonesian investors (ASrIA 2003), although some small investment firms such as Reksadana Kehati Lestari, a firm run by the environmental NGO Kehati, do employ such an approach. Crucial to a good outcome in this respect are large state-owned pension funds such as Taspen, Jamsostek and Astek. At present, these firms do not appear to employ such SRI strategies. Jamsostek places roughly 50-60% of the funds under its control in time deposits with private and state banks, 35% of its funds in bonds, and the rest in investments through a securities company (Summit Communications nd). Likewise, Taspen's investment strategy focuses on time deposits, bonds, and direct investments (Taspen nd). In both cases, the main concern seems to be on making secure investments with reasonable returns rather than making social and environmental sustainable investments. However, since there is evidence to suggest that socially responsible companies are more profitable, the

government could encourage them to shift to an SRI strategy without undermining their capacity to generate good and reliable returns. Another specific measure that the government could carry out in order to promote the use of SRIs by Indonesian investors is to support efforts initiated by Kehati to develop an SRI Index for the Indonesian Stock Exchange, along the lines of the existing Jakarta Islamic Index which assesses the extent to which listed Indonesian companies adhere to Islamic values.

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A Reassessment of Inequality and Its Role in Poverty Reduction in Indonesia[1*]

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INTRODUCTION

Many people and governments, especially in developing countries, put enormous faith in economic growth as the most essential indicator of progress in the well being of their populace. In the past few years, however, development economists have talked in more urgent terms about the importance of the quality of growth in addition to economic growth rates. This can be seen from the increased number of studies that measure the contribution of economic growth to widely used indicators that measure quality of life such as democracy, job opportunity, health, poverty reduction and income distribution.

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In this study, we focus on the issue of inequality. Before the onset of the economic crisis in mid 1997, there is little doubt that Indonesia had an extended period of high economic growth. There is still controversy however, about whether the benefits of this period of high growth were equally distributed among the whole population or were largely accrued only by the politically and economically well-connected minority. While popular perceptions strongly support the latter (Utomo 2004), the relatively abundant studies on inequality in Indonesia in general have failed to find quantitative evidence to support this popular belief and have found, in fact, that Indonesia's income inequality has been relatively low and stable. During the 1990s, Indonesia's Gini ratio—a widely used measure of inequality—was lower than neighbouring countries, such as Malaysia, Singapore, and the Philippines, and even lower than the average Gini ratio of high income countries (Sudjana & Mishra 2004).

We reassess the calculation of inequality measures by taking into account price disparities across regions in Indonesia. There is evidence of a significant price differential across regions in Indonesia, making the real value of the *rupiah* highly variable between regions. Although this differential should be considered in any study of inequality (Arndt & Sundrum 1975; Asra 1999), almost all previous inequality studies in Indonesia have ignored this aspect of Indonesian household expenditure data. By deflating the nominal expenditure with a regional price index, we ensure that every *rupiah* in our household expenditure data carries equal purchasing power across regions. For simplicity, we refer to the deflated expenditure as the real expenditure.

Since there is no published data available in Indonesia on regional price differentials, we use regional poverty lines that were calculated in Pradhan *et al.* (2001) as the regional price index. These regional poverty lines are based on a single national basket of goods multiplied by regional price levels, so that differences in the poverty lines across regions simply reflect the differences in the price levels across regions.

This study consists of two main parts. In the first part we reassess the evolution of inequality in Indonesia during the period between 1984 and 2002 using several widely used inequality measures with the monthly household per capita expenditure data taken from the Consumption Module Susenas (National Socioeconomic Survey). Since

this period covers both the pre-crisis high growth period and the crisis low growth period, we are able to conjecture how inequality evolves with economic growth.

In the second part of the study, we then examine the relationship between inequality, growth, and poverty. Specifically, we investigate whether the level of inequality affects the relationship between economic growth and poverty reduction. To do so, we utilize a model to estimate the "distribution-corrected" growth elasticity of the poverty rate using provincial level data.

Before proceeding further, it is useful to reiterate that inequality should not be used as the sole indicator for judging economic performance of a country. Inequality only measures the distribution of income or expenditure. At one extreme, this means that inequality does not exist in a country where everybody is poor. Thus, having a low level of inequality does not necessarily mean a country is doing well or a country has provided excellent social welfare to its people. Therefore, countries with higher inequality do not necessarily need to follow countries with lower inequality (Kaplow 2002).

By the same token, increasing inequality does not necessarily have a negative implication. For example, increasing the income of high-income individuals without decreasing the income of others will increase inequality, but it is better than nobody experiencing any increase in income at all (Feldstein 1998). This means that discretion should be exercised when looking at the results of inequality calculations. Although the calculations provide some insights into the condition of a country, they do not tell the whole story because, by itself, inequality does not even provide a partial analysis of welfare, let alone a comprehensive one.

INEQUALITY MEASUREMENTS AND LITERATURE REVIEW

We use two measures of inequality: Gini ratio and Generalized Entropy index.[2] The Gini ratio is the most widely used measure of inequality. This measure is calculated based on a Lorenz curve that is a cumulative frequency curve that compares a distribution (in our case,

[2] The explanation on Gini and Generalized Entropy is taken from World Bank (2005).

income or expenditure) to a uniform distribution that indicates perfect equality (usually population distribution). Figure 1 illustrates a Lorenz curve and the calculation of the Gini ratio. In the horizontal axis of this figure, the population is ordered from the poorest to the richest, with the Lorenz curve showing the cumulative distribution of their income. Meanwhile, the line of inequality is drawn based on the assumption that everybody in the population has the same income.

In this figure, Gini Ratio is simply calculated as:

$$Gini\ Ratio = \frac{A}{A+B} \tag{1}$$

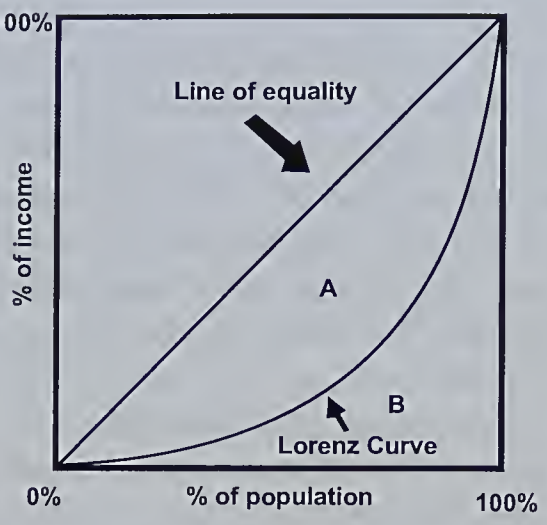
where A is the area between the line of equality and Lorenz curve, while B is the area below the Lorenz curve. If there is perfect equality, then the Lorenz curve will be right on top of the line of equality, which means area A is zero, implying a Gini ratio of zero. On the other hand, if there is perfect inequality, then area B is zero, implying a Gini ratio of 1.

The Generalized Entropy (GE) index is an inequality measurement defined by the following formula:

$$GE(\alpha) = \frac{1}{\alpha(\alpha-1)}\left[\frac{1}{N}\sum_{i=1}^{N}\left(\frac{y_i}{\bar{y}}\right)^{\alpha} - 1\right] \tag{2}$$

where $\bar{y}$ is the average income or expenditure, and represents the weight given to levels of well-being at different parts of the distribution. The most commonly used values of are 0 (sensitive to the lower end of the distribution), 1 (sensitive to the middle), and 2 (sensitive to the upper end). GE with value of 0 is called Theil's L while GE with = 1 is called Theil's T. The value of the GE index ranges from zero to infinity, with zero implying no inequality in the distribution.

Figure 1. Lorenz Curve and the Calculation of Gini Ratio



Research on Inequality in Indonesia

There have been a large number of investigations on the subject of inequality conducted within the Indonesian context (for example, Skoufias *et al.* 2000; Tjiptoherijanto & Remi 2001; Alisjahbana 2001; Akita & Alisjahbana 2002; Said & Widyanti 2002; Akita *et al.* 1999). Most of these studies use nominal expenditure data, hence disregarding the effect of regional price differentials on the differences in purchasing power across regions at the same level of nominal expenditure. An exception is Skoufias *et al.* (2000) who deflated household nominal expenditure with a household specific deflator.[3] Such a deflator, however, can only be constructed using panel data.

Akita & Alisjahbana (2002) focused on income inequality between 1993 and 1998 using district-level GDP and population data using the two-stage nested decomposition method. They concluded that overall income inequality measured by Theil index increased significantly over the 1993-1997 period, from 0.262 to 0.287, during which time Indonesia achieved an annual average growth rate of more than 7%. On the other hand, it declined to 0.266 during the crisis, which corresponded to the

[3] The deflator in their paper is household specific, while in this paper it is province-urban/rural specific (based on poverty line).

level prevailing in 1993-1994. This was supported by Tjiptoherijanto & Remi (2001). They also stated that inequality seemed to be more apparent in urban areas than in rural areas and declined during the period from 1996 to 1998, similar to the findings of Akita *et al.* (1999).

The finding of a decline in inequality during the crisis period is also consistent with the finding from a study by Said & Widyanti (2002). When they investigated inequality changes among the population below the poverty line, however, the result contradicted the trend of inequality in the entire population. The Gini and Theil indices for the population living below the poverty line actually increased during the crisis period. This is consistent with the finding of a study by Skoufias *et al.* (2000) who used the 100 Village Survey data that has a sample of relatively poor households. They calculated that the Gini Ratio of household-specific deflated expenditure increased from 0.283 to 0.304 during the crisis. This increase was especially driven by the significant rise in inequality in the rural areas, whereas in the urban areas, inequality slightly decreased.

DATA

We use the monthly household per capita expenditure deflated by a regional price index, and we call the deflated expenditure real expenditure. The data on nominal household expenditure are obtained from the Consumption Module Susenas, while the regional price index used is based on the regional poverty lines as calculated in Pradhan *et al.* (2001) extended to other years.

Susenas is a nationally representative repeated cross-section household survey that is conducted regularly by Statistics Indonesia (*Badan Pusat Statistik*/BPS), covering all areas of the country. Susenas usually consists of two parts. The first part is conducted in February each year and collects demographic and socioeconomic characteristics of households and their members. This part of the Susenas is known as the Core Susenas. The second part of the Susenas is called the Module Susenas. Every year, the module rotates between Health Module, Social & Cultural Module and Consumption Module, implying that each of these modules is conducted every three years.

The one used in this study is the Consumption Module, which collects very detailed data on household consumption expenditure.

There are two kinds of consumption items in the questionnaire: food and non-food items. In this study, we use the Consumption Module Susenas from 1984 to 2002, which means data from 1984, 1987, 1990, 1993, 1996, 1999 and 2002 survey years, where the sample size ranges from 45,415 to 64,406 households in 26 provinces of Indonesia.

Using expenditure as a proxy for income is a contentious issue (Robilliard *et al.* 2001; Mishra, 1997 for example). Basically the grievance centres on the notion that the rich save more of their income than the poor, and this means inequality calculations using expenditure data tend to underestimate the actual income inequality. This has obscured the reliability of using expenditure as a proxy for income to an extent that some found unacceptable. There are studies, however, that claim that consumption is a better measure of welfare than income (Attanasio *et al.* 2004; Blundell & Preston 1998). At least in the case of developing countries, household expenditure data is thought to be much more reliable than household income data.

Table 1. Data Summary of Susenas Expenditure and Pradhan's Poverty Line

Year	N	Nominal Expenditure				Poverty Line			
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max
1984	49965	19225.77	16180.34	1476	602376	14368.72	4391.53	10189.00	26904.84
1987	50954	24803.24	20492.01	2744	900694	17000.91	4894.67	12052.46	33174.64
1990	45415	31492.10	23747.21	5080	831653	19427.93	2195.75	15143.76	26461.90
1993	58906	48941.69	41363.19	5506	1906999	24964.25	2976.43	19466.20	30951.88
1996	59900	75744.11	72077.76	8338	3160063	34252.74	3640.04	27670.90	43402.59
1999	61483	152886.90	121651.40	19972	3769032	84948.11	7296.98	70199.00	
2002	64406	237008.90	268159.60	28390	21300000	98392.14	9553.97	81656.06	

In the mean time, Pradhan *et al.* (2001) calculated poverty lines that use the same food basket in all regions. This means the poverty lines can be compared between regions as the differences in regional poverty lines only arise from the differences in regional prices. Moreover, they use an iterative method to determine the true reference group. Table 1 shows the data summary of the Susenas nominal expenditure and Pradhan *et al.* (2001) poverty line for each survey year.

INEQUALITY IN INDONESIA, 1984-2002

Trends in Real Expenditure

As a first step, we look at the changes in the mean per capita real expenditure by deciles of per capita real expenditure over time in order to examine the differences in the trends of expenditure growth across different socioeconomic levels. By looking at these changes, we can observe whether economic growth in Indonesia has benefited the rich more than the poor or vice versa. Table 2 provides the index of the mean per capita real expenditure of all deciles from 1984 to 2002.

Table 2. Index of Mean Per Capita Real Expenditure by Decile (1984=100)

Year	I (poorest)	II	III	IV	V
1984	100	100	100	100	100
1987	118.25	117.96	119.34	118.92	117.82
1990	169.69	156.23	149.39	143.71	139.65
1993	187.40	171.35	164.15	158.46	153.67
1996	209.52	192.91	185.32	179.48	174.33
1999	187.05	169.92	160.87	153.59	147.68
2002	232.21	211.21	200.94	192.72	185.88

Year	VI	VII	VIII	IX	X (richest)
1984	100	100	100	100	100
1987	116.70	115.78	114.87	114.34	117.38
1990	136.00	132.24	129.44	127.22	128.98
1993	149.89	146.97	145.10	143.84	149.91
1996	170.48	167.46	165.65	164.51	177.99
1999	143.05	138.51	133.96	129.75	126.90
2002	180.55	175.63	172.38	169.87	176.02

Table 2 shows that during the high growth period from 1984-1996, the mean per capita real expenditure of the poorest decile increased by 110% (from 100 to 209.5), implying that economic growth improves the welfare of the poor.[4] Furthermore, this increase was the highest

[4] The highest jump occurred between 1987 and 1990, where the lowest decile's mean per capita real expenditure increased to 70% above 1984, while the highest decile's mean per capita real expenditure only increased to 30%. Timmer (2004) also found that 1987-1990 was one of only

compared to the increases in other deciles. In fact, from the lowest to the ninth decile, the increase in the mean per capita real expenditure was lower the higher the decile. The increase experienced by the ninth decile during the same period is only 65%. The increase experienced by the richest decile (78%) was, however, relatively high and comparable to the increase experienced by the fourth decile. This implies that the high economic growth during this period has, in general, been relatively pro-poor, with the exception that the richest decile grew faster than the middle deciles. The discussion on why it has been pro-poor and why the richest decile grew faster than the middle deciles is beyond the scope of this paper.

In 1999, due to the crisis, the mean per capita real expenditure of all deciles fell substantially, reflecting the negative impact of the crisis on the population at all socio-economic levels. Table 2 clearly shows, however, that the decline in the mean per capita real expenditure is larger the higher the decile, implying that better-off households were hit harder by the crisis. As a result, relative to the distribution in 1984, there was an improvement in expenditure distribution in 1999.

After recovery in 2002, the mean per capita real expenditure of all deciles bounced back and even slightly surpassed the 1996 level, except for the top decile. In terms of expenditure distribution relative to the base year of 1984, however, the growth of the mean per capital real expenditure of the top decile was still higher than the eighth and ninth deciles.

Gini Ratio

Table 3 provides the Gini ratios of per capita real expenditure from 1984 to 2002 for the whole country as well as disaggregated by urban and rural areas. The table shows that total inequality decreased from 1984 to 1990, then increased from 1990 to 1996, significantly decreased between 1996 and 1999, before finally increasing during the recovery period between 1999 and 2002.

In urban areas, the trend is roughly similar to total inequality, except inequality actually increased between 1984 and 1987. In contrast,

two periods between 1984 and 2002 where income growth of the bottom quintile was higher than average income growth.

rural areas experienced the opposite, where inequality decreased between 1984 and 1987. In terms of the relative magnitude of inequality between urban and rural areas, inequality in rural areas at any given year is always lower than that in urban areas.

These trends are consistent with the figures obtained from trends and ratios of deciles of expenditures discussed in the previous section. Furthermore, this trend is also consistent with the result from a recent study of inequality in Indonesia (Sudjana & Mishra 2004), although the actual ratios themselves are quite different since the study used nominal expenditure data. This finding is similar to Skoufias *et al.* (2000), the only study in Indonesia that also used deflated expenditures, which found that the Gini ratio decreased during the crisis.

Table 3. Gini Ratio of Per Capita Real Expenditure

Year	Urban	% change from previous year	Rural	% change from previous year	Total	% change from previous year
1984	0.35	-	0.32	-	0.35	-
1987	0.36	2.86	0.30	-6.25	0.35	0.00
1990	0.34	-5.56	0.26	-13.33	0.32	-8.57
1993	0.34	0.00	0.27	3.85	0.33	3.13
1996	0.36	5.88	0.28	3.70	0.34	3.03
1999	0.32	-11.11	0.25	-10.71	0.30	-11.76
2002	0.33	3.13	0.26	4.00	0.32	6.67

If we look at those below the poverty line, inequality actually increased slightly between 1996 and 1999, from 0.091 to 0.099. This shows that although inequality decreased in total, there was an increase in inequality among the poor, which was mainly caused by more people falling into poverty, hence the group became more heterogeneous. The increase in inequality among the poor is also the finding in Said & Widyanti (2002).

Generalized Entropy Index

The GE index is a class of inequality measurement that allows for an additive decomposition of inequality to the intra and inter-group level. This feature makes the GE index one of the most popular indices used in analysing inequality. Table 4 shows GE indices for =0. In choosing which is more relevant for Indonesia, our choice is based on

studies that showed that Indonesians are vulnerable to poverty (Suryahadi & Sumarto 2003; Chowdury & Setiadi 2002).[5]

Table 4. Generalized Entropy Indices

	GE(0)									
	Urban	Percentage Change	Rural	Percentage change	Total	Percentage change	Intra group	Percentage Change	Inter group	Percentage change
Year										
1984	0.2103	-	0.1640	-	0.2071	-	0.1749	-	0.0323	-
1987	0.2214	5.28	0.1524	-7.07	0.2044	-1.30	0.1712	-2.12	0.0332	2.79
1990	0.1906	-13.91	0.1133	-25.66	0.1648	-19.37	0.1369	-20.04	0.0279	-15.96
1993	0.1905	-0.05	0.1168	3.09	0.1764	7.04	0.1413	3.21	0.0350	25.45
1996	0.2062	8.24	0.1286	10.10	0.1882	6.69	0.1566	10.83	0.0315	-10.00
1999	0.1648	-20.08	0.1049	-18.43	0.1461	-22.37	0.1285	-17.94	0.0176	-44.13
2002	0.1809	9.77	0.1084	3.34	0.1674	14.58	0.1406	9.42	0.0267	51.70

Based on those studies, we choose to discuss the GE results mainly using GE(0), because GE(0) is more sensitive to changes in the lower tail of the distribution than GE(1) or GE(2).[6] The pattern of GE(0) is almost identical to the pattern of Gini coefficients, although the percentage changes are more extreme. By using the advantage of GE, which allows us to separate inequality into within and between components of urban and rural inequality, we observe that intra-group inequality (i.e., inequality within urban and rural areas) accounts for most of the inequality. There are several observations that can be made.

First, between 1984 and 1987, intra-group inequality decreased while at the same time inter-group inequality (i.e., inequality between urban and rural areas) increased. In order to explain this, we see that during the same period urban inequality increased while rural inequality decreased. This means that almost all intra-group decreases in inequality took place in rural areas. The opposite trend took place

[5] Suryahadi and Sumarto (2003) wrote that vulnerability to poverty is defined as the probability of falling below the poverty line. The total vulnerable group (TVG) includes all those who are currently poor plus those who are currently non-poor but have a relatively strong chance of falling into poverty in the near future. Between 1996 and 1999, TVG increased from 18.1% to 33.7%. Moreover, Chowdury and Setiadi (2002) provided the widely documented fact that when measured using a poverty line of USD 1/day, only 7.8% of Indonesians were poor in 2001 but increasing the line to USD 2/day caused the poverty rate to jump to 60%.

[6] The poverty line is in about the 15-20th percentile of the income distribution. This means that the vulnerable households are mostly located in around the 25th percentile.

between 1993 and 1996, where intra-group inequality increased while inter-group inequality decreased. If we look at the separate rural and urban inequalities, Table 4 shows that, in percentage terms, the increase in inequality in rural areas was greater than the increase in inequality in urban areas. So between 1993 and 1996, urban areas managed to keep the increase in inequality below that of rural areas and narrowed the gap between them.

Second, the calculations show that, although total inequality decreased in 1999, the percentage decrease in intra-group inequality was much smaller compared to the decrease in inter-group inequality and the intra-group's share of all-group inequality was the highest in 1999. This implies that there was a narrowing of the gap in inequality between urban and rural areas. On the other hand, between 1999 and 2002, the increase in inequality happened more between rural and urban areas rather than within areas, as shown by the large percentage point increase in inter-group inequality compared to intra-group. This means the effect of the crisis that had lessened inter-group inequality considerably had been totally reversed by 2002.

Said and Widyanti (2002) show that the decrease in inequality between 1996 and 1999 could probably be attributed to the fact that the crisis had hit high-income households disproportionately harder and this contributed to a reduction in the income gap. Moreover, this impact had been channelled through large shifts in relative prices that may have benefited those in the rural economy relative to those in the modern-formal economy (Remy & Tjiptoherijanto 1999). This is supported by the greater decline in inequality in urban areas than in rural areas, which is shown in this paper, although urban areas still had higher inequality than rural areas in 1999.

Looking at inequality in 2002, however, it is clear that high-income households have recovered to their pre-crisis level of income much faster, proven by the fact that the percentage point increase in inequality in urban areas was three times larger than in rural areas (assuming that high-income households are located in urban areas). In other words, they had been hit disproportionately hard by the crisis but also bounced back much faster, thus increasing inequality once again.

ASSESSING THE ROLE OF INEQUALITY IN POVERTY REDUCTION

Bourguignon (2004) stated that distribution changes (i.e., changes in inequality) have a powerful effect on poverty. He also said that it is important to consider growth and distribution simultaneously and that the connection between poverty, growth and inequality is very country specific. In addition to Bourguignon (2004), another study mentioned another aspect of the relationship between poverty, inequality, and growth (McCulloch *et al.* 2000). They stated that change in poverty can be represented by the sum of three components: a growth component with inequality constant, an inequality component with growth constant and a residual. This means inequality is an important aspect in poverty reduction and thus should be given more attention in poverty reduction efforts.

In formalizing the relationship between poverty, inequality and growth, Ravallion (1997) stated that there are two channels where inequality can affect poverty. The first channel is through the well-studied relationship between inequality and growth, then growth and poverty. High initial inequality retards growth, which in turn reduces the rate of poverty reduction. The second channel is the "growth-elasticity argument". The argument states that in a growth process where all levels of income grow at roughly the same rate, higher inequality means that the poor gain less in absolute terms than the non-poor. This means the poor will continue to have a lower share of the total income and increment through growth, which means the rate of poverty reduction must be lower. However, this also means that the poor will suffer proportionately less of the impact in the event of an economic contraction. Thus, both high and low inequalities have their own benefits and disincentives for the poor. The paper also found that higher inequality tends to entail a lower rate of poverty reduction at any given positive rate of growth.

Ravallion (2000) stated that there is a need for deeper micro empirical work on growth and distributional change because even small changes in overall distribution can matter greatly to how much the poor share in growth, and the absence of a correlation between growth and inequality does not mean inequality matters little (see the "growth-

elasticity argument"). In addition, the paper also stated that high or rising inequality is putting a brake on the prospects for poverty reduction through growth. The paper also warned however, that reducing inequality by adding further distortions to the economy will have unpredictable effects on growth and poverty reduction.

Motivated by the studies above, we aim to establish the role of inequality in poverty reduction in Indonesia. First, Table 5 provides the trends of poverty rate, GE(0) inequality measure and expenditure growth index in rural and urban areas so that we can see their trends 1984-2002.[7]

Looking at the mean expenditure index, the crisis nearly eliminated a decade's progress in mean expenditure in urban areas, taking the 1999 mean expenditure level almost back to the 1987 level, a huge drop from the height of the boom in 1996 where mean expenditure was 56% higher than its 1984 level. In 1999, the figure stood at merely 15% higher than 1984. Although, it bounced back by 2002, it is still lower than the pre-crisis level. Mean expenditure in urban areas also experienced the least positive change compared to rural and national figures.

In 1996, a year before the crisis hit, rural mean expenditure was 66% higher than 1984 while national mean expenditure was 75% higher than 1984. The crisis also did not have as detrimental an effect in rural areas and nationally compared to urban areas since in both areas mean expenditure was still 39% higher than 1984.[8] In addition, in 2002, the mean expenditures in both rural and national levels have not only bounced back but have increased higher than pre-crisis levels. Although urban areas changed the least, it has to be acknowledged that urban areas still have higher mean expenditure than rural areas, a fact that is not shown in Table 5.

Comparing poverty rates and mean expenditure, it is clear that as expenditure increased, the poverty rate declined. This result is in accordance with expectations. It is quite interesting to see that in urban areas, even though the mean expenditure index in 1999 was almost

[7] The total mean real expenditure index does not have to be between those of urban and rural areas. This is due to the fact that the total growth rates are weighted by the share of population in each area, and that the total expenditure growth rate can be higher than the growth rates that are calculated separately for urban and rural areas.

[8] This is consistent with Wetterberg *et al.* (1999).

the same as the 1987 level, the poverty rate was much smaller in 1999 than in 1987. This implies that there are many households just below the poverty line, because a 15% increase in expenditure reduced the poverty rate by almost half (see 1984 vs. 1999).

Table 5. Poverty Rate (%), GE(0) Inequality Measure, and Mean Real Expenditure Index (1984=100) in Urban and Rural Areas, 1984-2002

Year	Urban			Rural			Total		
	Poverty Rate	GE(0)	Mean Real Expenditure	Poverty Rate	GE(0)	Mean Real Expenditure	Poverty Rate	GE(0)	Mean Real Expenditure
1984	29.25	0.2103	100	65.1	0.1640	100	56.68	0.2071	100
1987	24.30	0.2214	112.81	54.08	0.1524	114.53	45.95	0.2044	116.67
1990	16.65	0.1906	123.67	39.72	0.1133	133.09	32.68	0.1648	134.87
1993	10.22	0.1905	140.76	32.86	0.1168	144.22	25.32	0.1764	151.71
1996	7.11	0.2062	156.45	23.28	0.1286	165.99	17.44	0.1882	174.53
1999	16.33	0.1648	114.97	33.93	0.1049	139.33	27.00	0.1461	139.38
2002	5.47	0.1809	152.23	17.61	0.1084	169.71	12.22	0.1674	181.27

On the other hand, the inequality and mean expenditure index mostly moved in parallel, with inequality increasing (decreasing) whenever expenditure increased (decreased). The exception is during the period between 1987 and 1990. Finally, the relationship between inequality and poverty is negative, except, once again, for the period between 1987 and 1990.

To see how inequality affects the poverty-growth relationship, we utilize a model used by Ravallion (1997) to see the "distribution-corrected" growth elasticity of poverty rate, which takes into account the level of inequality in calculating the effect of economic growth on poverty reduction. The model explicitly assumes that higher inequality reduces the growth elasticity of poverty. We use provincial level data from 1984 to 2002 in order to get enough observations.[9] The estimation result is:

$$r = -3.699(1 - I)g + residual, \tag{4}$$

[9] From the 26 provinces in Indonesia, we gathered 153 observations between 1984 and 2002 ((6 x 26)-3=153). The three provinces of Aceh, Papua and Maluku were not surveyed in 2002 because of the civil unrest.

with a heteroskedasticity corrected standard error of 0.81 and an R^2 of 0.29, where r is the rate of growth of poverty rate between two periods, I is the initial Gini ratio, and g is the growth rate between the two periods. The results imply that economic growth significantly reduces poverty.

For the purposes of our paper, joint F-tests reject two tests with null hypothesis that only growth matters and that only "distribution-corrected" growth matters.[10] This means that the poverty-reducing effect of growth depends on the state of inequality.

In conclusion, it is evident that high inequality reduces growth elasticity of poverty. Our results show that the higher inequality is, the less impact growth has on poverty reduction. This finding explains why the poverty rate between 1999 and 2002 decreased very rapidly: because inequality in 1999 was at its lowest, thus the impact of growth on poverty reduction is high.

CONCLUSION

In this paper, we reassess the trend of inequality during Indonesia's high growth and crisis eras and examine whether inequality is related to poverty. Different from previous studies, we explicitly take regional price differences into account. There are several interesting results worth reiterating.

First, we found that inequality was actually at its lowest in 1999 with quite a mixed pattern: it decreased between 1984 and 1990, increased between 1990 and 1996, dropped in 1999 before finally increasing in 2002. Second, disaggregating by rural and urban areas revealed that intra-group inequality accounted for most of the inequality in Indonesia. Hence, we have established is that inequality between urban and rural areas in Indonesia is relatively lower than the inequality between the rich and the poor in each area. Third, the fact that in 1999 inequality was at its lowest while the poverty rate was higher than the 1993 level suggested that two things happened during the crisis: people in higher deciles lost more than people in lower deciles. This

[10] This is different from the result obtained by Ravallion (1997). Putting in fixed-effects or random-effects did not remedy the situation. We believe, however, that our result still shows the importance of inequality in the relationship between poverty and growth.

caused inequality to decrease and there was enough decrease in the expenditure of people in lower deciles that some who were not poor before the crisis became poor because of the crisis, thus increasing the poverty rate.

Finally, we provided evidence for the importance of reducing inequality as a means to increase the impact of economic growth on poverty reduction. Empirically, we found that inequality influences the growth elasticity of poverty in the way that the elasticity decreases as inequality increases. At high levels of inequality, growth would have less effect on Indonesia's quest to reduce poverty. This is partly proven by the fact that poverty reduction between 1999 and 2002 was very successful, that inequality in 1999 was at its lowest level in 15 years and resulted in the increased impact of growth on poverty reduction.

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Recent Political Developments

Political Stability and Party Dynamics

Sunny Tanuwidjaja

MULYANI'S "RESIGNATION"

The latest and most significant political development in Indonesia is marked by the resignation of Sri Mulyani from her post as the Finance Minister. She has been heralded both nationally and internationally as the icon of Indonesian bureaucratic reform. There is no question that she has been one of the reformists, if not the key technocrat, in promoting a clean government in Indonesia. She has played a key, if not a central, role in navigating Indonesian economy to avoid an economic catastrophe in the midst of global economic crisis.

SBY 2009 election victory was due to his ongoing success in promoting economic development and bureaucratic reform. There was no doubt and very difficult to argue otherwise that Mulyani had been playing a key role in these two SBY's achievements. However, her reform mindedness and her exceptional ability in managing the Indonesian economy could not save her from the political assaults of those who resisted and were worried of the adverse implications of the current progressive reforms promoted by Mulyani. Even the legitimately elected and currently still very popular president could not (or was unwilling to) keep her in his cabinet.

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On May 2010 it was announced that Sri Mulyani was resigning from her cabinet post and would be taking a position at the World Bank in Washington. She became one of the three World Bank Managing Directors with the post to oversee development programmes in Latin America, the Caribbean, the Middle East, North Africa, Asia and the Pacific. SBY received Mulyani's resignation letter on 5 May 2010 and approved it on that day showing that the unfolding of the event did not occur without prior knowledge of the president. One source closed to Mulyani revealed to the press that she told high rank officials in the Finance Ministry during breakfast meeting that she had been ordered by SBY to take the job at the World Bank while she never applied for the job[1].

Mulyani's exit was unexpected but it was not surprising. It was unexpected for two reasons. First, as the Bank Century scandal moved from the political into the legal process, the most likely outcome was that the allegation that Mulyani was involved in corruption would be unfounded. In addition, in the aftermath of the political process culminated in voting in the DPR plenary session where the majority of the parliament members voted to for the conclusion that there were indications of corruption in the Century Bank bailout process and alleged that the bailout itself had some legal problems, SBY publicly delivered a speech saying that he supported the policy of saving the Century Bank arguing that it was a necessary step to avoid an economic collapse.

Second, SBY is entering his second and last term as president. It was expected that he wanted to leave a strong legacy as a president and thus would be much more aggressive and bold in pursuing reform initiatives. Supporting a proven reform minded technocrat like Mulyani would be a key step to ensure the continuity of reform in Indonesia.

Apparently this was not the case. SBY allowed (or encouraged or forced) Mulyani to resign. Although unexpected, this move was not surprising. SBY has been known to put priority on political stability and he has been quite successful in maintaining one in the past six years. However, this success had been under threat lately where his coalition partners namely Golkar, PKS, and PPP had not been as loyal as expected. They had been taking part in criticizing SBY led government

[1] "SBY political deal may be behind Mulyani's exit," *The Jakarta Post*, 6 May 2010.

particularly in the Century Bank bailout by openly taking a position different from the one expected (or demanded) by SBY's camp. SBY understood that in order to maintain acceptable political stability he needed supports from the majority of parties in the parliament.

Defection by Golkar, PKS, and PPP opened the possibility for PDI-P to join the government coalition. However, PDI-P congress, and of course with the approval from Megawati in April 2010, openly rejected the idea of PDI-P joining SBY's coalition and proclaimed that PDI-P would maintain its opposition stance. This limited SBY's choice of coalition partners and made it difficult for SBY to find a substitute for Golkar in order to maintain majority support in the parliament. With this constraint, it was not surprising that at the end SBY had to incorporate Golkar back into his coalition.

The inability and probably unwillingness of SBY to keep Mulyani in his cabinet despite praising her as the bedrock for Indonesia's economic progress and saying that her exit was a big loss for Indonesia show that maintaining political stability and avoiding continuous political turmoil are the main priorities of the president. Only a few days following Mulyani's resignation, SBY along with his coalition partners established a Joint Secretariat, which aimed to "improve communication and coordination" among coalition parties.

SBY was the chairman of the Secretariat while Aburizal Bakrie was appointed as the executive chairman. What had been revealed to the public in the media was that the purpose of creating this Joint Secretariat was to improve "communication" and "coordination". However, it is not difficult to read that what "communication" and "coordination" mean in this case is a process of negotiating or bargaining the political and financial interests of those who are parts of the government coalition.

The Democratic Party and Golkar are the primary winners from the political controversy of Century. From the beginning, the Century case is a hot political commodity. Many politicians, both from the opposition parties as well as from the government coalition parties considered this case as a political opportunity. The special committee meetings in the DPR, which in essence were interrogation processes of those who were considered responsible for the "mismanagement" of the Century bailout, were publicly broadcasted in the national televisions.

With such public exposure, the politicians from the opposition parties as well as from coalition parties taking part in these meetings attempted to use the occasions to gain popularity, and public sympathy and support. It was not uncommon to hear them speak "in the name of the public" and argued that the public was very concerned with this issue. The politicians attempted to build a public opinion that the "people" were aware and very concerned with the Century issue. Evidence apparently says otherwise.

Indonesian Survey Institute released a national survey showing that after months of political disputes on the Century case, there was not much of a change regarding the support of existing political parties compared to the 2009 legislative election[2]. In addition, 80% of the public considered the performance of the president to be good while only 56% and 48% of the public said the same thing about the lawmakers and political parties respectively. This shows that the Century drama has not produced the political gain as expected by the politicians. At the end, by rejecting Democratic Party's offer to join the government coalition, PDI-P has gained nothing from the Century case. Golkar, who behaved exceptionally inconsistent as the primary partner of the Democratic Party, has been rewarded by regaining all of its cabinet posts and by the ousting of Sri Mulyani.

SELECTIVE REFORM UNDER AGUS MARTOWARDOJO [3]

The appointment of Agus Martowardojo to replace the recently "ousted" Sri Mulyani Indrawati as the finance minister has received positive responses from both politicians and the market. There is no doubt that Agus has a strong track record, and thus it is natural that optimism runs high with his appointment. Filling the big shoes left by Mulyani is no easy task for anyone, particularly when expectations run high as they are today. Thus, we should be careful with our optimism and instead be realistic.

Of course, there is a reason to be optimistic if we look at the track records, experiences, and characters of Agus whom the president has

[2] "Incentives for Opposition parties: Lessons from the Century Case, " Indonesian Survey Institute, press release, 9 May 2010.

[3] This section is from the article the author wrote in The Jakarta Post on 22 May 2010, "From Sri Mulyani to Martowardojo: a Continuity".

confidently chosen to replace Mulyani. Particularly on the issue of bureaucratic reform, Agus' achievement in propping Bank Mandiri up as the leading bank in Indonesia through internal reforms has been heralded as one of the reform "miracles" in Indonesia's reform era.

With this track record, the general public and the market expect that Agus can continue the bureaucratic reform that Mulyani began and to some extent has implemented quite successfully. There is no doubt that Mulyani is the one who spearheaded the reform in her ministry and has set high standards for others. One can confidently say that her series of achievements is one of the reasons why President Susilo Bambang Yudhoyono has been perceived by the public to have successfully implemented bureaucratic reform.

Despite having a highly qualified individual replacing Mulyani, we have to realize that the overall political context has not changed dramatically. Related to the continuity of the bureaucratic reform agenda, there is a reason to be cautious because the overall political context has the tendency to encourage only selective reforms, i.e., reforms only on aspects that do not threaten political and financial interests of those in power.

Mulyani's experience warns those who are too optimistic that political considerations matter most. Mulyani's experience should teach us that the existing Indonesian political context is willing to sacrifice exceptionally capable individuals for the sake of short-term political gains. In the name of maintaining political stability, harmony and the pursuit of "government effectiveness", too progressive individuals can be sacrificed. To put it bluntly, reform minded and capable individuals will still face difficulties challenging politicians who have a strong appetite for short-term political and financial gains.

The political continuities are easily observable. We still have a president who needs a strong support from the political parties and he seems to put political stability, harmony and "government effectiveness" as his main priorities. Thus, he will continue to work hard to avoid another "Bank Century bailout" saga in the future. This means that when the reform agenda puts political stability and harmony at risk, there is no reason and evidence yet to think that Yudhoyono will choose the former over the latter.

We still have politically powerful politicians in the political parties who have strong business interests. As Mulyani mentioned in one of her speeches, it is not uncommon for politicians with business interests to take part and influence the decision and policy making processes in the government.Agus, with his highly qualified credentials, massive experiences and strong character, will be able to pursue some degrees of reform, but it is questionable whether he will pursue reforms that may have the potential to threaten the political and financial interests of those who have strong political bases and supports. One other question remains: Will Yudhoyono sacrifice another "Mulyani" in order to secure political stability and harmony, or will he be courageous enough as Mulyani was, not to be dictated by any interest when it comes to pursuing a progressive reform? Whether SBY will be remembered as a president who is able to navigate Indonesia through the challenges of reform or as an unassertive or even worst a half-hearted reformer will be written as a history. Only time will tell.

POLITICAL PARTIES

After Aburizal Bakrie was elected as the new Golkar chairman through a heated competition with Surya Paloh, Megawati's reelection as PDI-P chairwoman, followed by Anas Urbaningrum's success in capturing Democratic Party (PD) chairmanship, the reelection of Hilmi Aminuddin as the chairman of PKS and Majelis Syuro and Anis Matta as the secretary general wrapped up the cycle of internal party competition of the four biggest parties in Indonesia.

Partai Demokrat (PD)

Anas' victory came as a surprise because many expected that Andi Mallarangeng would win the chairmanship. The primary reason was the SBY's factor. Initial reading seemed to show that SBY leaned towards Andi. All cabinet ministers from PD supported Andi, along with businessmen closed to SBY's circle and senior politicians within the party. Yahya Sacawiry who headed the *Badan Pemenangan Pemilu* (election team) even defected from Anas to Andi's camp. Most important indicator of course was the fact that SBY's son strongly supported Andi. The result of election was far from expected. Andi did not even gain enough vote to go to the second round. Anas received 236 votes,

Marzuki Ali (the ex party secretary general) received 209 votes, while Andi surprisingly came last with only 82 votes. In the second round, Anas defeated Marzuki by receiving 280 out of 530 votes despite Andi's public support for Marzuki Alie.

Anas' victory was attributed to several factors, among which three were the most important ones. Compared to Andi, Anas had been part of PD longer and was known to maintain relations with the local party leaders. However, Andi during most of his career in the party was associated with key positions in the government under SBY. This was a crucial distinction. Marzuki's success in gaining significant supports was a strong evidence of the importance of this factor.

Marzuki was the most senior compared to the other two candidates and was the secretary general of the party, which meant that he had intense interactions with the local party leaders. The fact the Marzuki was in conflict with Hadi Utomo (the previous chairman of PD) and was forced to resign as a secretary general a year before the election and yet was able to gain significant support showed that his interaction and relationship with local party leaders pay great dividends.

The second factor was Anas' HMI (Indonesia Muslim Association)[4] connection which provided him with additional local links, and also financial as well as political supports from the centre. Lastly, it was Anas's maneuver to gain the blessing of SBY's mother-in-law. Tempo reported that Mrs. Sarwo Eddhie liked Anas due to his calm manner, and her blessing encouraged SBY to not openly and explicitly support Andi's bid. This hurt Andi, who anchored his campaign for chairmanship on SBY's support.

It is unclear whether Anas will have enough freedom to maneuver because within the PD structure there is the Dewan Pembina led by SBY, which has the authority to nullify chairman's decision. Anas was asked by SBY to accommodate both Marzuki's and Andi's camp in order to maintain unity and harmony, and looking at the new members of PD's Central Executive Board, one can easily observe this accommodation. The biggest concern now is whether this highly accommoda-

[4] HMI is a campus-based organization in which many politicians were its members. It is common for its alumnus to maintain influence and connections with each other and with other members from different generation.

tive PD's "cabinet" can work together and whether the grudges among candidates from the competition has come to an end.

Partai Keadilan Sejahtera (PKS)

PKS second national congress ended with the announcement by the party of its commitment to openness and pluralism. However, the affirmation was not too convincing and looked half-hearted. Key leaders of the party kept mentioning the same thing, i.e., that the party would now allow non-Muslim to become member of the party and take part in any leadership role without any clear change within the party's charter. On more concrete cases, such as the banning of Ahmadiyah, the spread of shariah-based local laws, and in cases which involved violence done by extremist groups, PKS politicians have failed to capitalize the opportunities to show that they have truly changed. Instead, they continue to stay silent on these issues.

Similar to Megawati's reelection as PDI-P's chairwoman, there is nothing surprising about PKS' new leadership. The pragmatist camps within PKS still control the party as shown by the reelection of Hilmi Aminuddin and Anis Matta. Both are known for their pragmatic approaches to politics. This shows that pragmatist camps (known as the prosperous camps) within PKS have been able to consolidate their power within. However, internal conflict and competition are not yet ended. There is an emerging tension within this faction as indicated by the competition between Hilmi and Hidayat in the recent second national party congress.

Although both camps within the prosperous faction agreed the needs to be electorally successful and to expand PKS support base beyond the Muslim conservatives thus requiring a more pragmatic approach, the Hidayat camp believed that pragmatism promoted by Hilmi's camp had gone a little bit too far, for example by seeking supports from businessmen with weak legal credentials. The Hidayat camp sees PKS not only as a party but also a part of a socio-religious movement (Ikhwanul Muslimin/IM), and thus still has and needs moral credibility and authority. Only when it is fully detached from IM that PKS can pursue such a pragmatic approach. The goal of PKS by being more pragmatic and inclusive is to become one of the three biggest parties in 2014 election. In order to be successful PKS has to solidify itself internally by resolving its internal tension.

The Indonesian political context provides reasons for PKS to be optimistic. There is a declining tendency of voters' identification towards political parties. As shown by LSI survey, in November 2008, party identification was at its lowest of 15 percentage level.[5] This opens the possibility for voters to switch from one party to another. Despite a trend towards the personalization of politics (i.e. the focus on personal individual figures instead of on parties) in Indonesia, and despite the fact that SBY can still be a political asset for PD in 2014, it is still unclear and somewhat unlikely that another public figure as charismatic and popular as SBY will emerge by 2014.

Considering PKS has an organizational advantage, this situation is going to be beneficial for PKS. This however does not reduce the urgency of PKS to find popular figures within its party considering the tendency of personalization of politics in Indonesia. Related to this is PKS ability to mobilize using its party organization that will be advantageous for PKS because it is likely that election turnout will decline further in 2014.[6] The plan to increase parliamentary threshold from 2.5 percent will reduce the number of parties competing in the upcoming election. While voters from small centrist parties will be divided among seven parties, PKS will only have to compete with PPP for the voters from minor Islamist parties, in which PKS has a clear advantage. It is thus not surprising if PKS can perform much better in 2014 than in 2009.

ASPIRATION FUND

As the Century case loses its steam because there are indications that the investigation process has not yet found illegal acts in the Century bailout process, Golkar throws another controversial idea. Golkar suggested that the government should put aside IDR15 billion for each electoral district. With 77 electoral districts in Indonesia, the total fund reaches up to IDR8.5 trillion. This suggestion finds a strong resistance from the public as well as from government officials. Even political parties within the Joint Secretariat such as PAN and PKS rejected the idea.

[5] "Tendency of Swing Voters Towards the 2009 Election," Indonesian Survey Institute, press release, November 2008.

[6] Turnout in 1999 is 91%, in 2004 it is 84%, and in 2009 it is 70%

The main concern raised by many is the potential for corruption. The proposed process of disbursing the aspiration fund was dominated by DPR members. Theoretically, local government or DPR members from particular electoral districts can propose a project according to the aspiration of the local people. Then both the executive representative along with the Budgeting Committee from the parliament will assess the proposal. If approved, DPR member(s) from the electoral district has the responsibility to monitor the disbursement and usage. The presence of DPR members in almost all phases of the process and the fact that it was the DPR members who first proposed this idea make the public suspicious.

Beyond the concern of corruption, the reasoning behind this idea is weak at best. The first argument for this aspiration fund is for creating equal development. At the moment, inequality across region is a fact in Indonesia. Logically, if all get equal amount of money instead of giving more to the less developed, inequality will certainly persist. We already have a decentralization fund, or commonly known as general allocation fund (*Dana Alokasi Umum*/DAU) for each district and the amount depends on a relatively rigid formula which takes into account variation in level of development. If DAU is not working, why not amend it instead?

The second argument is that by having this new budget, it will help regions which lack lobbying skills since some special allocation funds require some capacity of lobbying by the local government. One should note that special allocation fund (*Dana Alokasi Khusus*/DAK) is much smaller compared to the DAU. If lobbying is the problem, why not help the local government build that capacity instead of creating a new budget post? The third reasoning for the need of aspiration fund is the disbursement process of the existing fund is controlled by "fund or budgeting mafia". Again, having an additional fund will not solve the problem. It even opens a new opportunity for the so-called mafia. Instead, why don't the DPR members optimize their monitoring function and minimize the activity of the mafia?

CONCLUSION

The main lesson from the recent political development is that Indonesian politics is still marked by continuities. Political stability is

Indonesia's main priority since it is a prerequisite for the continuity of economic development. The question for SBY was however whether political stability could have been maintained without ousting Mulyani. As in the aftermath of the 2004 election, the period post-2009 election is marked by stability. Despite initial concerns coming from the Century case, it seems that major political powers have found the set up to postpone their bickering until the 2014 election.

Reform will continue but it will not be as aggressive as in the past. As long as it does not disturb the interests of major political actors, reform will gain significant progresses in the next three years. Major political parties will compete for the centrist voters and there are signs that political parties are stepping up their efforts to maintain their public presence by organizing different social events. Finally, financial pressures on parties will force them to find alternative sources of fund, which the aspiration fund could be one of the many options.

Recent Economic Developments

STEADY GROWTH CONTINUES

Widdi Mugijayani

OVERVIEW

Along with the improvement of global economic conditions, Indonesia's economy is going stronger. Growths in Indonesia and other developing countries, such as Brazil, China and India are quite steady and strong. In Q1-2010, economic growth reached 5.7% (y-o-y), a much higher growth than 5.4% (y-o-y) in the previous quarter. All at once, it recorded the highest economic growth since the global recession started in the mid of 2008. Therefore, it is hoped that government's assumption of 5.8% economic growth would be achieved. Meanwhile, in February 2010, the yearly inflation rose slightly to 3.8% from 3.7% in the previous month. In contrast, a 0.14% monthly deflation occurred in March. This decline in price, particularly rice price, is due to seasonality when the harvest started in that month. However, inflation picked up from 3.4% in March to 5.05% in June. Although the seasonal increases of spice prices mostly caused the high inflation in June, inflationary pressures might be greater in the coming months of July through September due to the 10% basic electricity price hike in July, the start of school year, Ramadan fasting month, and the Idul Fitri holiday.

In the early of 2010, Rupiah (IDR) exchange rate against US dollar (USD) showed the highest level with around IDR9000/USD. Yet, in April, it suddenly fell by around 2%. This weakening was predicted

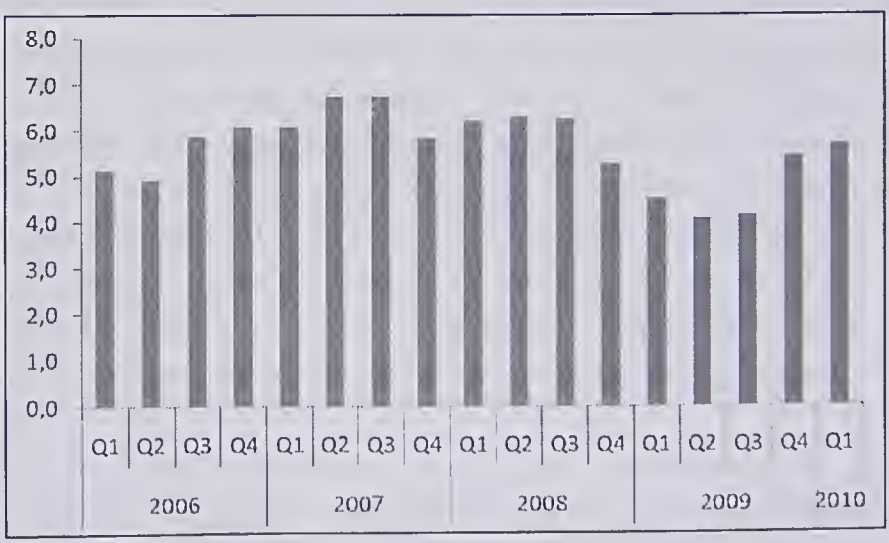
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to be temporary as this was only the market's reaction to the Greek financial crisis and the announcement of resignation of the Indonesian financial minister. Those positive indicators have increasingly reinforced optimism for a continuing process of economic improvement and are expected to attract investment and capital flowing in. Besides, this improvement in investment climate is also supported by the various government infrastructure projects, such as One Stop Service (OSS), a one-stop service system for investing in Indonesia.

ECONOMICS GROWTH

In Q1-2010, Indonesia recorded a 5.7% growth (y-o-y), a much higher growth than the 5.4% in the previous quarter (see Figure 1). On the quarter basis, the economy grew by 1.9% compared to Q4-2009. It was the highest economic growth since the global recession started in the mid of 2008. Therefore, given this figure, it is hoped that government's target of 5.8% economic growth would be achieved. According to the latest IMF projection, economic growth was predicted to reach around 6%. This was because IMF assessed that the government had appropriate fiscal and monetary policies in addressing the dynamics of global economy. These policy objectives are not only to safeguard macroeconomic and financial system stability, but also to strengthen domestic economic resilience.

Figure 1. GDP Growth (y-o-y), Q1-2006 – Q1-2010 (%)



Source: CEIC Asia Database

In spite of the upbeat in the economy generally, the real sector provided a mixed trend. Based on some indicators, for example, vehicle sales and residential property index showed an improvement, while other indicators such as cement sales and business tendency index experienced a decline. Motor vehicle sales increased from 47.9 thousand units in December 2009 to 52.7 thousand units in January 2010, while residential property index rose to 132.8 in Q4-2009 from 131.8 in the previous quarter. Motorcycle and motor vehicle sales increased by 13% and 17% respectively compared to the previous month. Nevertheless, these increases could not be counted as increases in investment because they affected household consumption more. On the contrary, business tendency index declined from 112.8 in Q3-2009 to 108.4 in Q4-2010. According to March data, retail sales index and consumer confidence index were stable.

On the production side, for the most sectors, yearly growth rates exhibited stable rates compared to 2009. The main sources of Q1-2010 growth were trade-hotel-restaurant and transport-communication sector, which contributed 1.6% and 1% respectively, while the lowest contribution came from electricity-gas-water with 0.1%. Nevertheless, based on yearly sectoral growth, the highest growth was experienced by transport and communication (11.9%), while the lowest was experienced by agriculture (2.9%) (see Table 1).

On the expenditure side, household consumption as the major engine of growth continued the stable path with a small tendency of weakening, which grew by 3.9% (y-o-y). Meanwhile, gross fixed capital formation rose by 7.9% after having been at its lowest level in 2009 as a consequence of the global financial crisis. Strong growths in both export and import reached 19.6% and 22.6% respectively, also as a result of last year's deteriorating external demand for Indonesian products and Indonesian demand for foreign products. On the other hand, the government consumption has decreased by 8.8%; this reversed last year's high growth (see Table 2).

EXPORT AND IMPORT

In April 2010, export was recorded around USD12,774.4 million or 5.7% lower than export of previous month but 43% higher that export of last year's April. This decrease was affected by non oil and gas ex-

port decline of 7.1% or around USD 9,849.1 million. In contrast, oil and gas export experienced a slight increase of 1.6% to USD 2,202.6 million. The idea of world's recovery seems to be reflected by the fact that the latest export values have been back to their levels in early 2008.

Table 1. GDP Growth Components and Source of Growth: Production Side (%)

		Q4-2009 to Q1-2010	Q1-2009 to Q1-2010	Source of Growth Q1-2010 (y-o-y)
1	Agriculture	18.1	2.9	0.4
2	Mining	-1.9	3.5	0.3
3	Manufacturing	-1.0	3.6	0.9
4	Electricity, Gas and Water	-2.7	7.2	0.1
5	Construction	-2.2	7.3	0.5
6	Trade, Hotel and Restaurant	0.0	9.3	1.6
7	Transportation and Communication	1.5	11.9	1.0
8	Finance, Real Estate and Business Services	2.5	5.5	0.5
9	Services	0.2	4.6	0.4
	GDP	**1.9**	**5.7**	**5.7**
	GDP Non Oil and Gas	**2.1**	**6.1**	

Source: Statistics Indonesia

Table 2. GDP Growth Components and Source of Growth: Expenditure Side (%)

	GDP Components	Q4-2009 to Q1-2010	Q1-2009 to Q1-2010	Source of Growth Q1-2010 (y-o-y)
1	Household Consumption	9.9	3.9	2.3
2	Government Consumption	-44.4	-8.8	-0.6
3	Gross Fixed Capital Formation	-2.3	7.9	1.8
4	Export of Good and Services	-4.1	19.6	7.7
5	Minus Import of Good and Services	-2.3	22.6	6.7
	GDP	**1.9**	**5.7**	**5.7**

Source: Statistics Indonesia

Table 3. Non Oil and Gas Export by Countries of Destination

	Destination Countries	FOB Value (USD Million)				Change of April 2010 over March 2010 (USD Million)	% Share Total Non Oil and Gas Jan-Apr 2010
		March 2010	Apr-10	Jan-Apr 2009	Jan-Apr 2010		
	ASEAN	2348.4	2178.8	5610.4	8262.7	-169.8	21.35
1	Singapore	914.1	814.4	2449.6	3095.6	-99.7	8.00
2	Malaysia	625.4	655.5	1333.5	2316.8	30.1	5.99
3	Thailand	323.2	285.4	639.0	1178.4	-37.8	3.04
	Other ASEAN Countries	485.7	423.5	1188.3	1671.9	-62.2	4.32
	EU	1409.8	1070	3819.3	5063.9	-339.8	13.08
4	Germany	232	193.3	618.8	871.4	-38.7	2.25
5	France	91.9	80.8	258.1	411.4	-11.1	1.06
6	England	137.3	132.8	433.3	568.3	-4.5	1.47
	Other EU Countries	948.6	663.1	2509.1	3212.8	-285.5	8.30
	Other Main Countries	4608.3	4340.5	10994.9	16979.8	-267.8	43.88
7	China	1095	929.8	2274.4	4018,0	-165.2	10.38
8	Japan	1330.9	1243.3	3108.2	4926.3	-87.6	12.73
9	USA	1094.8	1058.5	3106.1	4054.6	-36.3	10.48
10	Australia	169.2	181.2	538.5	646.7	12.0	1.67
11	South Korea	632.4	638.7	1204.6	2296.8	6.3	5.94
12	Taiwan	286.0	289.0	763.1	1037.4	3.0	2.68
	Total of 12 Destination Countries	6932.2	6502.7	16727.2	25421.7	-429.5	65.69
	Other	3673.6	3346.4	10170.4	13275.4	-327.2	34.31
	Total Non Oil and Gas Exports	10605.8	9849.1	26897.6	38697.1	-756.7	100.00

Source: Statistics Indonesia

As for Indonesia's export destination, Indonesia's major trading partner is ASEAN countries, accounting for 21.35% of total non oil and gas export. Besides ASEAN, Japan remains the dominant market with non oil and gas export share of around 12.7%, followed by the United States and China (Table 3). Nevertheless, export destinations trend began shifting. Nowadays, export to Asian countries, such as China and South Korea increases rapidly.

Like export, in April, import tended to climb up reaching its pre global crisis level around USD11534.2 million, and grew by 5.1% compared to import in March. In additions, between January and April, import increased to USD41495.4 million or by around 60.8% compared to the same period in 2009. Regarding import by countries of origin, there was not a significant change compared to Q4-2010. China continued to dominate with 17.3% of Indonesia's total import, followed by Japan (15.2%) and Singapore (10.3%), while, ASEAN as a group still dominated the import market with 23.63% share of Indonesia's total import (Table 4). Based on economic category, raw material took up the largest share with 72.7% (Table 5). Meanwhile capital goods and consumption goods only accounted for around 19.8% and 7.5% respectively.

Yuan revaluation and flexibility, pledged by the People's Bank of China on 19 June 2010, will be positive for the economy especially on the trade sector, according to Bank Indonesia. However, since most exports to China are natural resource-based commodities, which are more sensitive to Chinese demand rather than exchange rate movement, this gain will be constrained.

Table 4. Non Oil and Gas Import by Countries of Origin

	Countries of Origin	CIF Value (USD Million)				Change of April 2010 to March 2010 (USD Million)	Share to Non Oil & Gas Imports Jan-Apr 2010
		March 2010	Apr-10	Jan-Apr 2009	Jan-Apr 2010		
	ASEAN	2623.7	1993.5	4762.2	7678.3	-270.2	23.63
1	Singapore	996.1	846.1	2496.6	3356	-150.0	10.33
2	Malaysia	744.0	641.6	1166.1	2421.8	-120.4	7.45
3	Thailand	363.0	383.1	850.1	1413.5	20.1	4.35
	Other ASEAN	160.6	122.7	249.4	487	-37.9	1.50
	EU	749.7	793.4	2522.8	2841.8	43.7	8.74
4	Germany	249.9	230	705.5	885.8	-19.9	2.73
5	France	71.5	115.3	401.5	322.3	43.8	0.99
6	England	70.3	93.3	259.3	163.6	23.0	0.50
	Other EU	358	354.8	1156.5	1470.1	-3.2	4.52
	Other Main Countries	4525.9	4709.1	11196.3	16146.8	193.2	49.68
7	Japan	1349.0	1433.6	2779.7	4949.1	84.6	15.23
8	China	1340.2	1483.4	3794.9	5610.4	143.2	17.26
9	USA	868	751.7	2049.9	2994.8	-116.3	9.22
10	Australia	426.2	497.3	1082.9	923.5	71.7	2.84
11	South Korea	330.3	303.7	897	1217.4	-26.6	3.75
12	Taiwan	212.2	239.4	591.9	451.6	27.2	1.39
	Total of 12 Origin Countries	7020.7	7018.5	17075.4	24709.8	-2.2	76.03
	Other	1699.9	1753.4	4316.8	7788.9	53.5	23.97
	Total of Non Oil & Gas Imports	8720.6	8771.9	21392.2	32498.7	51.3	100.00

Source: Statistics Indonesia

Table 5. Import by Economic Category

Economic Category	CIF Value (USD Million)				Change (%)		Share to import Jan-Apr 2010*) (%)
	March 2010	April 2010 *)	Jan-Apr 2009	Jan-Apr 2010 *)	Apr 2010*) over Mar 2010	Jan-Apr 2010 *) over Jan-Apr 2009	
Total Imports	10972.6	11534.2	25800.5	41495.4	5.12	60.83	100.00
Consumption Goods	868.8	917.8	1832.8	3095.2	5.64	68.88	7.46
Raw Materials	7897	8333.7	18356.1	30169.4	5.53	64.36	72.70
Capital Goods	2206.8	2282.7	5611.6	8230.8	3.44	46.67	19.84

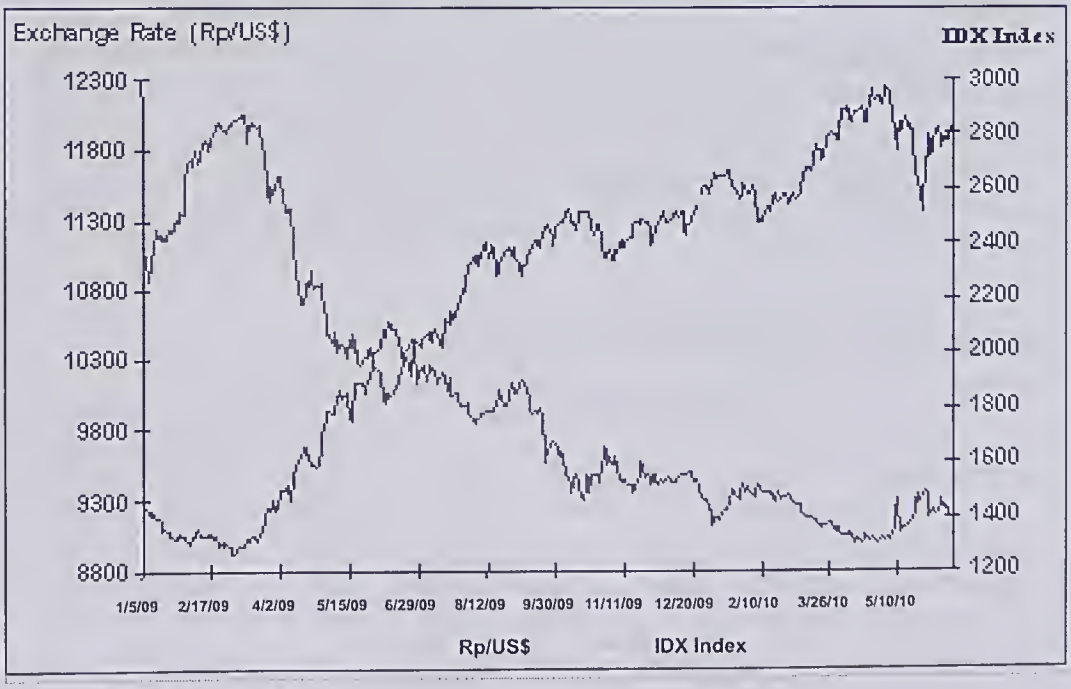
Note:*) Preliminary data

Source: Statistics Indonesia

EXCHANGE RATE AND INFLATION

In Q1-2010, Rupiah (IDR) exchange rate against USD and Indonesia's Composite Index (IDX) were relatively stable. The stock market was bullish and the composite index increased sharply while IDR continued to appreciate in February 2010. The bullish stock market also followed the higher trading in the regional market. Afterwards, IDR continued to appreciate and reached its highest value of IDR9,070/USD at the end of March, while the composite index has been amounting up to 2,819. Yet, on 6 May both of them suddenly fell by around 5% and 2% respectively. This weakening was predicted to be temporary as this was only the market's reaction to the Greek financial crisis and the announcement of resignation of the Indonesian financial minister. During May 2010, the composite index rose by around 5% while IDR exchange rate managed to hover around IDR9,000/USD. The IDR was strengthened following the Yuan revaluation on 21 June 2010 in expectation of greater exports and increased purchasing power by the middle-class Chinese.

Figure 2. Exchange Rate and IDX Index, January 2009 – May 2010



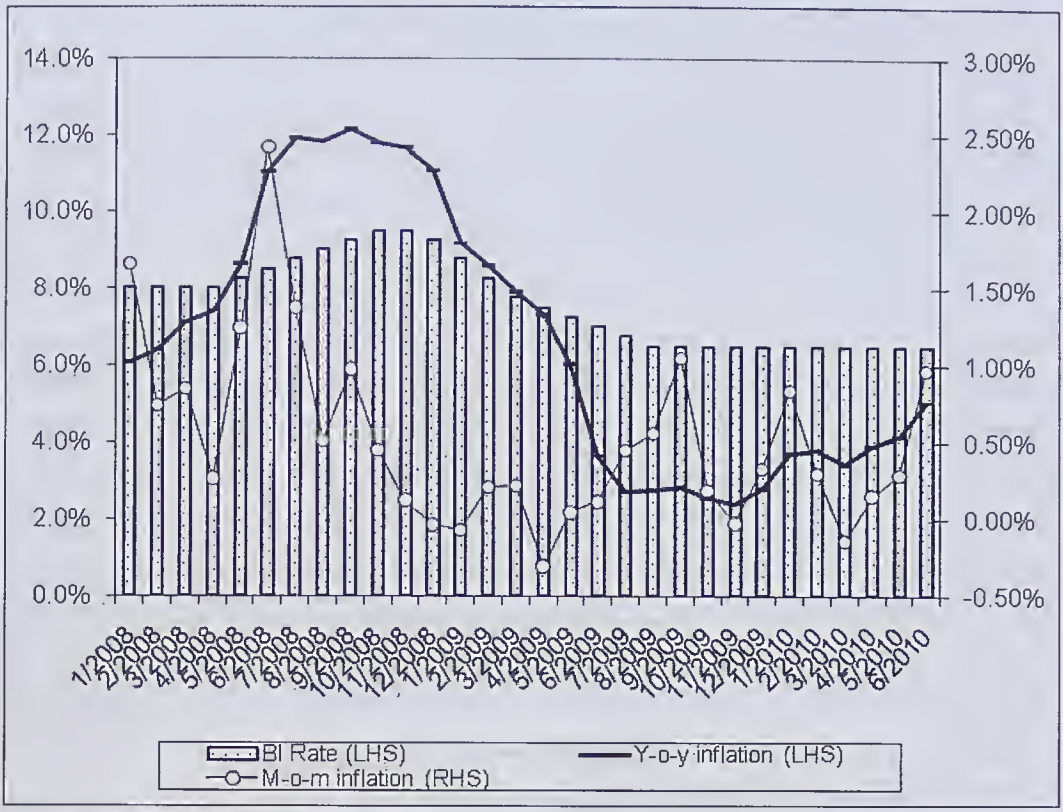
Source: CEIC Asia Database

In January 2010, monthly inflation was relatively high, reaching 0.8%. Meanwhile, the yearly inflation increased to 3.71% in January 2010, the highest since the mid of 2009. This was mainly due to a significant increase in food price, particularly rice price. The rice price increased by 2.6% on average, even some regions experienced an increase of more than 15% to IDR8000 per kg. In contrast, a 0.14% monthly deflation occurred in March, with the yearly inflation decreasing from 3.8% in February to 3.4% in March, which was mainly coming from the decrease in price of food items i.e. rice and chili. This decline was due to the harvest that started that month. A month after, the monthly inflation rate was 0.15% and the yearly inflation was 3.9%. It has been showing an increasing trend since then: 4.2% in May and 5.1% in June. The higher inflation in June was due to the sharp increases in prices of food, especially rice, red chili, and onions, as well as prices of clothing and cigarettes. Strong inflationary pressures on basic commodities may continue if the government fails to remove bottlenecks in the distribution of basic commodities, including infrastructure problems, flooding, and illegal food hoarding, according to the Central Statistics Agency (BPS) chief.

Furthermore, the monetary authority kept BI rate at the same level of 6.5%. This rate has not changed since the mid 2009 as inflationary pressures in recent months were seasonal and were still within the 4-6% target range. Besides, the aim of the low BI rate was to stimulate investment. But unfortunately, it had failed to induce banks to reduce their lending rate which dropped only slowly. Banks' poor performance in the provision of credits was the major reason of their reluctance to reduce lending rate. Related to credit, in early 2010, credit experienced a negative growth compared to the previous month. This negative growth was due to the negative investment credit growth of 2.7%. This was also evidence of credit access problem.

Meanwhile, foreign entities holding Indonesia's Central Bank Certificate (or SBI) fell in early July by more than 15% that those of a month before. This reflected Bank Indonesia's newly introduced financial regulations issued in mid June including a one-month minimum holding period for SBIs and an extension of the tenors of SBIs to nine and 12 months from one, three, and six months.

Figure 3. BI Rate and Inflation, January 2008 – June 2010



Source: CEIC Asia Database

OUTLOOK 2010

Looking ahead, assuming there will be no further changes that could considerably affect the economy, the government-predicted GDP growth of 5.8%, or the even higher, IMF-estimated GDP growth of 6%, seems achievable. In the upcoming months, export and import values are likely to increase. In the months of July to September, we can expect some upward pressures on inflation because of the 10% basic electricity tariff hike, the start of school year, the Ramadan fasting month, and the Idul Fitri holiday. More inflationary pressures in the fourth quarter might make the Central Bank increase the interest rate in line with the trend of the other regional economies. Also, property boom—due to an influx of foreign investment as the government is preparing to open up the property market—might put pressures on inflation in the coming periods. There was also a plan by the Vice President to float the currently subsidized gas price although the time to implement it was unclear.

According to Institute for Management Development (IMD) Switzerland, in terms of competitiveness, Indonesia was ranked 35 from around 60 countries surveyed in 2010. The rank calculation was based on several criteria namely economic performance, government efficiency, business efficiency and infrastructure. The survey also indicated several indicators that showed some improvements such as current account balance, exchange rate, inflation, investment incentives and labor regulations. On the other hand, other indicators—such as, government budget deficit, subsidies, stock market capitalization and direct investment flows—have shown some declines. To achieve the targets, the major challenges for Indonesia are improvements of physical infrastructure, efforts to fight bureaucratic corruption, improvement in processing regional investment in the decentralized Indonesia, managing the influx of continuous huge capital flows and reducing poverty and income/economic gaps through increased social investment.

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